No. 79-843

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In the Supreme Court of the United States

OCTOBER TERM, 1979

EXXON CORPORATION,

Appellant,

vs.

SOUTH CAROLINA TAX COMMISSION,

Appellee.

On Appeal From the Supreme Court of South Carolina

JURISDICTIONAL STATEMENT

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PAGE

II. The Assessment Of South Carolina Tax On Income Derived From Appellant's Exploration And Production Functional Operations Outside The State Constitutes A Construction Of S. C. Code §§12-7-250 and 12-7-1130 Which Violates The Due Process Clause Of The Fourteenth Amendment To The United States Constitution 23

III. The Assessment Of South Carolina Tax On Income Derived From Appellant's Exploration And Production Functional Operations Outside The State Constitutes A Construction Of S.C. Code §§12-7-250 and 12-7-1130 Which Violates The Commerce Clause Of Article One Of The United States Constitution 28

IV. With The South Carolina Supreme Court's Decision Herein, A Conflict Has Arisen Between Both The Highest Courts Of Various States And With A Federal Circuit Court Of Appeals In The Treatment Of Exploration And Production Income Of An Oil And Gas Company 31

Conclusion 33

Appendix—

A. Decision of South Carolina Supreme Court ....App. 1

B. Order And Opinion Of The South Carolina Court Of Common Pleas .....App. 16

C. Notice Of Appeal And Proof Of Filing And Service .....App. 40

D. South Carolina Code §§12-7-250 .....App. 43

E. South Carolina Code §§12-7-1130 .....App. 44

F. Complaint .....App. 45

G. Schedule A .....App. 51

CASES CITED

PAGE

Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U.S. 271, 45 S.Ct. 82 (1924) 15, 19, 22, 23

Butler Bros. v. McColgan, 315 U.S. 501, 62 S.Ct. 701 (1942) 11, 15, 18, 22, 23, 25, 26, 27, 33

General Motors Corporation v. Washington, 377 U.S. 436, 84 S.Ct. 1564 (1964) 29

Hans Rees' Sons v. North Carolina, 283 U.S. 123, 51 S.Ct. 385 (1931) 11, 16, 19, 21, 22, 23, 24, 25

Magnolia Petroleum Co. v. Oklahoma Tax Commission, 190 Okla. 172, 121 P.2d 1008 (1942) 28, 32

Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 98 S.Ct. 2340 (1978) 19, 22, 23, 25, 26, 27, 29, 33

National Bellas Hess, Inc. v. Department of Revenue, 386 U.S. 753, 87 S.Ct. 1389 (1967) 24

Shaffer v. Carter, 252 U.S. 37, 40 S.Ct. 221 (1920) 28

Skelly Oil Company v. Commissioner of Taxation, 269 Minn. 351, 131 N.W.2d 632 (1964) 31, 32

Standard Oil Co. v. Thoresen, 29 F.2d 708 (8th Cir. 1928) 32, 33

Standard Pressed Steel Co. v. Washington, 419 U.S. 560, 95 S.Ct. 706 (1975) 29

State ex rel. Maxwell v. Kent Coffey Manufacturing Co., 204 N.C. 365, 168 S.E. 397, aff'd 54 S.Ct. 437 (1933) 10, 15

Tenneco, Inc. v. Barr, 224 So.2d 208 (Miss. 1969) 32

Texas Company v. Cooper, 236 La. 380, 107 So.2d 676 (1959) 28, 32, 33

Webb Resources v. McCoy, 194 Kan. 758, 401 P.2d 879 (1965) 28, 32, 33

STATUTES CITED

PAGE

S.C. Code §§ 12-7-250 .....14, 23, 24, 27, 28

S.C. Code §§ 12-7-1130 .....14, 23, 24, 27, 28

ADDITIONAL AUTHORITIES

United States Constitution

Due Process Clause (Amend. XIV, §1) 14, 15, 23, 27, 29

Commerce Clause (Art. I, §8, cl. 3) 28, 29

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OPINIONS BELOW

The opinion of the Supreme Court of South Carolina is reported at 258 S.E.2d 93; the order and opinion of the South Carolina Court of Common Pleas is unreported. Copies of the foregoing are set forth, respectively, in Appendices A and B at pp. App. 1 and App. 16.

JURISDICTION

Jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1257(2), this being an appeal which questions the validity of S.C. Code §§12-7-250 and 12-7-1130 on the ground that they are repugnant to the Constitution of the United States, the validity of which was upheld by the Supreme Court of South Carolina.

The opinion of the Supreme Court of South Carolina was filed on September 5, 1979. No rehearing was had or requested. The Notice of Appeal was filed with the Supreme Court of South Carolina on November 20, 1979, a copy of which is set forth in Appendix C at p. App. 40.

Jurisdiction of this Court pursuant to 28 U.S.C. §1257(2) is supported by the following decisions:

Hans Rees' Sons v. *North Carolina,* 283 U.S. 123, 51 S.Ct. 385 (1931)
Butler Brothers v. *McColgan,* 315 U.S. 501, 62 S.Ct. 701 (1942)
Moorman Manufacturing Co. v. *Bair,* 437 U.S. 267, 98 S.Ct. 2340 (1978).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Commerce Clause (Art. I, §8, cl. 3):

> "The Congress shall have power . . . to regulate commerce with foreign Nations and among the several States, and with the Indian Tribes;"

Due Process Clause (Amend. XIV, §1):

> "[N]or shall any State deprive any person of life, liberty, or property, without due process of law;"

The pertinent parts of S.C. Code §§12-7-250 and 12-7-1130 are set forth in Appendices D and E, pp. App. 43 and 44, respectively.

QUESTIONS PRESENTED

1. Whether the State Court's assertion that Appellant's total corporate operations constitute a single business operation which is unitary for purposes of state taxation, thereby subjecting virtually all of Appellant's corporate income to apportionment, has rendered S.C. Code §§12-7-250 and

12-7-1130 invalid under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

2. Whether the assessment of income tax by the State of South Carolina on Appellant's Exploration and Production income derived outside the State from extraction of oil and gas, thereby refusing to allocate such income to situs, constitutes a construction of S.C. Code §§12-7-250 and 12-7-1130 which renders the statute invalid under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

3. Whether the assessment of the income by the State of South Carolina on Appellant's Exploration and Production income derived outside the State from extraction of oil and gas, thereby refusing to allocate such income to situs, constitutes a construction of S.C. Code §§12-7-250 and 12-7-1130 which renders the statute invalid under the Commerce Clause of the United States Constitution.

Appellant directs the Court's attention to the Jurisdictional Statement filed September 26, 1979 in *Exxon Corporation* v. *Wisconsin Department of Revenue,* Docket Number 79-509, as to which probable jurisdiction has already been noted. While the general issues in that case are virtually the same as in the present case, Appellant requests that the two cases not be consolidated for briefing and oral argument since the state statutes and the state supreme courts' analysis thereunder are different. Moreover, Wisconsin included in apportionable income all income from production except third-party sales, whereas South Carolina in this case has included all production income in apportionable income.

STATEMENT OF THE CASE

A. CORPORATE ORGANIZATIONAL HISTORY.

Exxon Corporation ("Exxon") was formerly named Standard Oil Company (New Jersey) which prior to the name change in late 1972 was the parent of a wholly owned subsidiary corporation named Humble Oil & Refining Company ("Humble"). At about the time of the name change Humble was merged into Exxon, making Exxon the legal successor to Humble, the original taxpayer in this action.

B. APPELLANT'S CORPORATE STRUCTURE AND CORPORATE OPERATIONAL PATTERN.

Appellant's corporate structure during the years at issue consisted of three parts, Corporate Management, Coordination and Services Management and Operations Management. Corporate Management was composed of a board of directors, an executive committee, a chairman of the board, a president and various directors-in-charge who were members of the board of directors. The Coordination and Services Management consisted of corporate staff departments with the responsibility of providing the overall specialized corporate services that were needed by the corporation.

Operations Management was responsible for directing the operating activities of the three major functional departments of Appellant which consisted of Exploration and Production, Refining, and Marketing. Each functional department operated independently of each other.

The Exploration and Production functional Department was actually composed of three segments, Exploration, Production and Natural Gas. Exploration had the responsibil-

ity for the acquisition of reserves of crude oil and gas. Production was responsible for the development and production of all of Appellant's oil and gas reserves. Natural Gas was responsible for the sale, purchase and distribution of natural gas.

The Refining Department was responsible for the operation of Appellant's refineries and related facilities which manufactured petroleum products, special products and chemical feed stocks. The Marketing Department was responsible for the distribution and sale of petroleum and specialty products.

Each of the functional operating departments had its own management group. Each functional department was a separate profit center. In addition, each department was a separate investment center, and separate records were maintained for each of these departments to reflect the investments in properties and fixed plant. Each operating department had its own separate accounting office which maintained accounting records and prepared financial reports of its operations.

Appellant did not have any crude oil or natural gas production in the State of South Carolina, nor did it have any refineries located in the State of South Carolina. Thus, only Appellant's Marketing Department operated in South Carolina.

C. UTILIZATION OF THIRD-PARTY TRANSFER PRICES.

It was the policy of Appellant that the transfer prices or values for products and raw materials passing between the three major functional departments, *i.e.,* Exploration and Production, Refining and Marketing, should be based upon competitive conditions similar to dealing at arms' length with an outside company. There was no company

requirement for crude oil produced by Appellant to flow through to its refineries or for its refined products to flow through to its marketing outlets. Appellant's crude was either sold to third parties or transferred to its Refining Department depending upon which method would be most economical. Oil being a fungible commodity, the Refining Department was interested primarily in the quality of crude oil and in a stable supply. The crude oil which Appellant produced was handled in one of two different ways. It would either be sold to third parties (almost half of its production) on the basis of the posted field price for the field in which the crude was produced plus the applicable tariff for transportation, or it would be transferred from Production to Appellant's Supply Department (a non-profit center for the purchase, sale and distribution of crude oil) and then on to the Refining Department also based on the posted field price plus transportation costs. Thus, the cost to Refining would be the same as if the crude had been purchased from a third party producer.

A posted field price was a published price which indicated what a purchaser was willing to pay for crude oil from a particular field. It was a publication of the price at which crude oil would be purchased if it was in fact purchased. The posted field prices were printed on bulletins by the company which was purchasing the crude oil, and it was a bona fide competitive price. Any disposition of crude oil by Appellant was made at the posted field price, whether the distribution was a transfer to Appellant's Refining Department by Supply or a sale to third parties by Supply.

The posted field price was the price utilized by Appellant to pay royalty owners under leases that permitted Appellant to produce the oil. This price was also used by Appellant to pay for oil purchased from any parties having

working interests in any particular wells or leases. Whenever Appellant sold crude oil to third parties the posted field price was used as the sales price. Supply, in turn, when it transferred crude to the Refining Department, transferred it at the posted field price. The posted field price was also utilized for purposes of computing depletion for federal income tax purposes, and for computing the severance tax due to producing states.

None of Appellant's natural gas went to the Refining Department for product conversion. The only gas that went to the Refining Department was used for fuel consumption and amounted to approximately three percent of Appellant's natural gas. All of the gas sold by Appellant was sold in the states where it was produced. The Natural Gas segment of Appellant's Exploration and Production Department did not have any activities in the State of South Carolina. All natural gas sold by Appellant to third parties was sold at a negotiated price pursuant to contract negotiations with those third parties. All natural gas purchased by Appellant was also purchased pursuant to negotiated contracts. Any internal transfer of gas by Appellant was based upon third party contracts in effect at the time of the transfer.

D. ACCOUNTING PRACTICES IN THE PETROLEUM INDUSTRY AND THE USE THEREOF BY APPELLANT.

In the oil industry the posted field price was a figure at which crude oil was bought and sold in the market at various places. For accounting purposes posted field prices were accepted as the equivalent of third party transactions.

Pursuant to accounting principles, a multifunctional oil company can ascertain derived income from its exploration and production function by accumulating data starting at

the individual oil or gas well and that data can be consolidated into larger groups and built up until it involves the entire exploration and production function of the company.

Appellant pursuant to generally accepted accounting principles was able to ascertain the net income derived from its Exploration and Production Department.

There was no accounting relationship between the investments of the Exploration and Production Department and the marketing operations of Appellant in the State of South Carolina.

E. REPORTING AND AUDIT PATTERN IN THIS CASE.

Appellant timely filed its South Carolina corporation income and franchise tax returns for the calendar tax years 1970 through 1972. These returns were prepared and the computation made by allocating the income from the Exploration and Production Department to the appropriate situs state and by apportioning the balance of Appellant's income under the South Carolina formula. Thus, Appellant's exploration and production income was excluded from the apportionable income to which the South Carolina apportionment ratio was applied.

On audit, the exclusion of exploration and production income was disallowed and Appellant's tax liability was calculated by applying the South Carolina apportionment ratio to the total net income of the corporation less certain minor items. As a result, the amount of Appellant's income subject to apportionment during the years 1970-1972 was increased by the addition of $24,649,057. Additional taxes in the amount of $1,478,944 were thereby assessed.

Importantly, at no stage was the accuracy or validity of Appellant's separate functional accounting figures challenged or even questioned.

HOW THE FEDERAL QUESTIONS WERE RAISED AND DECIDED BELOW

Upon the disallowance of the exclusion of Appellant's Exploration and Production Department income from apportionable income, Appellant made payment to the South Carolina Tax Commission, under protest, of an additional tax for the calendar years 1970, 1971 and 1972 in the amount of $1,490,855 plus interest in the amount of $229,-863.10. Appellant then brought an action in the South Carolina Court of Common Pleas pursuant to S.C. Code §65-2262 for the recovery of such taxes and interest. Among the allegations in the Appellant's complaint, which is set forth in Appendix F, p. App. 45, is the following contained in paragraph 15 at p. App. 49:

> "If defendant's method of computing plaintiff's taxable income is held to comply with S.C. Code §§65-222, 65-222.2, 65-259(8), 65-2[79].2 and 65-2[79].1,* then one or more of said statutes, on its face or as applied to plaintiff, is in violation of the due process clause of the Fourteenth Amendment of the United States Constitution, and the commerce clause of Article I, §8(3) of the United States Constitution."

After a hearing on the merits, before Special Judge Joseph R. Moss of the 5th Judicial Circuit of the South Carolina Court of Common Pleas, the trial court rendered its decision, see Appendix B, *infra,* p. App. 16. The decision of the Court of Common Pleas was in favor of the Tax Commission and Appellant appealed to the South Carolina Supreme Court. The State Supreme Court affirmed the decision of the trial court and, with certain exceptions, merely adopted the opinion of the trial court as

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* South Carolina has renumbered its Statutes. The sections in controversy here are S.C. Code §§12-7-250 and 12-7-1130 which were previously numbered §§65-222.2 and 65-279.2.

its own. However, the Supreme Court did make several notable deletions from the trial court's opinion. In particular, the Supreme Court of South Carolina deleted the factual analysis of the Appellant's corporate operations made by the trial judge. The Supreme Court of South Carolina also deleted the factual statements of the trial court regarding the Appellant's South Carolina activities. For convenience, reference will be made to the original opinion published by the South Carolina Supreme Court and citations will be to that opinion as set forth in Appendix A.

In its opinion, the South Carolina Supreme Court held first that Appellant's business was unitary in nature. In reaching that conclusion, the court applied a combination of what it described as the "unities" concept and a "contribution-dependence" test:

> "In my opinion, the proper answer to the question of whether or not a business is unitary in nature is given in terms of whether or not the business possesses the characteristics of unity of ownership, unity of management and unity of operation and whether or not the activities of the business in question contribute to or depend on the activities of the business." (App. A at p. App. 7)

In defining its terms, the court specifically rejected the contention of Appellant that the activities of a business are not unitary if they "might be maintained as an independent business (however convenient and profitable it may be to operate them co-jointly)." *State ex rel. Maxwell* v. *Kent Coffey Manufacturing Co.,* 204 N.C. 365, 168 S.E. 397, *aff'd* 54 S.Ct. 437 (1933). The trial court engaged in an extensive discussion of Appellant's corporate structure (deleted by the Supreme Court) and concluded that, since the Appellant used centralized management techniques to control personnel and insure profit stability and "made no

attempt to externally identify its exploration and production activities as a separate business," the Appellant during the years in question "was a single unitary business comprised of the exploration and production of crude oil and natural gas, the refining of crude oil and the marketing of natural gas and refined petroleum products." (App. A at p. App. 8)

Second, the trial court examined the activities of Appellant in South Carolina and held that those activities were "substantial" thereby justifying the additional assessment of tax imposed by the Tax Commission. In reaching this conclusion, the trial court noted that Appellant had sold gasoline and oil in South Carolina for over thirty continuous years and had approximately 1300 gasoline stations in the state. The trial court also took notice of the South Carolina Tax Commission's "success" in tracing gasoline from the Appellant's refinery at Baytown, Texas to the Port of Charleston, South Carolina (deleted by the Supreme Court) and placed particular stress upon Appellant's owning and operating a "massive facility" at Charleston. In view of these findings, the court rejected what it termed to be the "overreach allegation" of Appellant, and put particular emphasis upon *Butler Brothers* v. *McColgan,* 315 U.S. 501, 62 S.Ct. 701 (1942). In so doing, the trial court attempted to distinguish the case of *Hans Rees' Sons* v. *North Carolina,* 283 U.S. 123, 51 S.Ct. 385 (1931) which had prohibited the State of North Carolina from taxing a percentage of a multistate corporation's income which was out of all appropriate proportion to the business transacted within North Carolina:

> "The *Hans Rees* decision may be distinguished from the later *Butler Brothers* case on the ground that the California formula of property, payroll and sales more accurately measured the contribution of *Butler Brothers'* California activities to the corporation's unitary income. South Carolina has employed a formula based

upon these three principles. If *Hans Rees* cannot be distinguished from *Butler Brothers,* the latter decision of course controls." (App. A at p. App. 12)

Thus, the trial court, through a combination of factual and legal justifications, found that the Due Process Clause was satisfied since "the tax in question clearly bears fiscal relation to the protection, opportunities, and benefits given [Appellant] by this State." (App. A at p. App. 14)

Third, the state court rejected the argument of Appellant under the Commerce Clause that South Carolina had engaged in multiple taxation by including in the apportionable income figure that situs income derived from Appellant's exploration and production business. The court noted that the record did not disclose whether Appellant was taxed on more than 100% of its income by all states combined. The court further stated that severance taxes, which are levied by the situs states, are not income taxes, but rather are privilege taxes. Consequently, the state court concluded that multiple taxation did not result from levying taxes on different incidents such as requiring a person to pay property, privilege, and income taxes.

From the decision of the South Carolina Supreme Court, Appellant has appealed to this Court. The decision of the Supreme Court of South Carolina in favor of the validity of the South Carolina taxing statutes, as applied by the South Carolina Tax Commission, is in violation of the Due Process and Commerce Clauses of the United States Constitution and raises valid and substantial Federal questions.

THE FEDERAL QUESTIONS ARE SUBSTANTIAL

As noted above, Appellant in the present case has docketed a Jurisdictional Statement in *Exxon Corporation* v. *Wisconsin Department of Revenue,* Docket Number 79-509, which deals with the same general issues as here. Appellant suggests that the Wisconsin case confirms that the

federal constitutional questions raised herein are substantial in both their nature and incidence.

The federal questions presented are not only substantial but they are basically issues of first impression, such as to require plenary consideration, with briefs on the merits and oral argument, for their resolution. Appellant *is not* raising such timeworn issues as (1) the right of a state to tax income derived in that state from operations of a multistate corporation, (2) the right of a state under appropriate circumstances to employ an appropriate apportionment formula, or (3) the validity of the three factor formula of South Carolina when properly applied.

The new and substantial concepts which are challenged in this appeal may be summarized as follows: (a) the concept that a total corporate entity can be found to be unitary, thereby subjecting virtually all the total corporate income to an apportionment formula, based only upon an examination of the corporation's management structure and the non-delineation publicly of its separate operational functions; (b) the concept that clearly identified situs income becomes a part of the total unitary income and, hence, subject to the application of an apportionment formula; and (c) the concept that multiple taxation as a burden on interstate commerce depends on the fact, rather than on the power, of a situs state to tax. It is necessary for this Court to reverse these erroneous concepts of law, as pronounced by the South Carolina Supreme Court, so as to articulate the law of state taxation in a manner consistent with unanimously contrary pronouncements by other state supreme courts and a lower federal court. It is also necessary for this Court to specifically reject the application of the South Carolina apportionment formula which results in multiple taxation and a burden on interstate commerce. As noted above, all of these new and substantial federal questions involve either the Due Process Clause or the Interstate Commerce Clause or both.

I. THE SOUTH CAROLINA SUPREME COURT, BY FINDING THAT APPELLANT'S TOTAL CORPORATE BUSINESS WAS UNITARY, HAS INTERPRETED S.C. CODE §§12-7-250 and 12-7-1130 IN A MANNER THAT VIOLATES THE DUE PROCESS CLAUSE OF THE FOURTEENTH AMENDMENT TO THE UNITED STATES CONSTITUTION

Section 12-7-250 reads, in part, as follows:

> "If any taxpayer . . . is transacting or conducting his business partly within and partly without this State, the income tax as provided in this chapter shall be imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State. . . ."

Section 12-7-1130 reads, in part, as follows:

> "The income less all related expenses from any other investments, including investments in subsidiaries, the net income from which is not properly includable in the net apportionable income of corporations engaged in interstate commerce under the Constitution of the United States because it is unrelated to the business activity of the corporation conducted partly within and partly without South Carolina, shall be allocated to the State in which the business situs of the investment is located . . ."

South Carolina Tax Commission Regulation §117-87.17 reads, in part, as follows:

> "The phrase 'transacting or conducting his business partly within and partly without the State of South Carolina' . . . is applicable to a single business operation, which is unitary or homogenous and is carried on both within and without the State. . . . A Taxpayer operating a unitary or homogenous business within and without the State and an unrelated business either entirely within or without shall be subject to the allocation formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. The income from the unrelated business shall be directly assignable to the state where such business is conducted."

In interpreting these statutes and the Tax Commission Regulation, the South Carolina courts relied primarily on the decision of this Court in *Butler Brothers* v. *McColgan, supra.* The *Butler Brothers* decision was interpreted by the South Carolina courts as defining "unitary" to mean whether or not the business possesses the "characteristics of unity of ownership, unity of management and unity of operation and whether or not the activities of the business in question contribute to or depend on the other activities of the business." (App. A at p. App. 7) The South Carolina courts specifically rejected the argument of Appellant that a business should not be considered unitary if the several activities of the business might be maintained as independent businesses. See *State ex rel. Maxwell* v. *Kent Coffey Manufacturing Co., supra.*

Using the unitary business concept to reach situs income clearly unrelated to Appellant's South Carolina marketing operations does not pass constitutional muster under the Due Process Clause of the Fourteenth Amendment to the United States Constitution when compared to all other decisions of this Court. Only four decisions of this Court have even touched on the "unitary" concept in connection with state taxation, and none of these decisions lends support for its application to an industry such as the oil and gas industry where the exploration and development function is capable of calculating its derived income independent of the refining and marketing functions.

In *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission,* 266 U.S. 271, 45 S.Ct. 82 (1924), this Court was presented with a challenge to the constitutional validity of a New York statute providing for an annual franchise or

privilege of doing business tax in New York on foreign corporations. The tax was measured by the net income of the corporation, and the tax was determined by the proportion of the value of certain assets within the state compared to the total value of all such assets located everywhere. This Court found that Bass, Ratcliff was engaged in the unitary business of manufacturing and selling ale, that the practice of manufacturing resulted in no profits until there were sales, and that as such the State Tax Commission was justified in attributing to New York for taxation a just proportion of the profits earned by Bass, Ratcliff from the unitary business. This Court pointed out that it did not believe that the application of New York's statutory taxation method produced an unreasonable result or was inherently arbitrary or an attempt to reach profits earned elsewhere. It was stressed that there was no evidence in the record to determine if Bass, Ratcliff had received any net income from its New York business or the amount of any profit or loss on that business when either considered separately or together with the manufacturing business done in Great Britain. Notably, the controlling factor was the facts, or lack thereof, not any basic "unitary" concept.

In *Hans Rees' Sons* v. *North Carolina, supra,* this Court considered a challenge to the North Carolina income tax as assessed against Hans Rees' pursuant to a single factor (property) apportionment formula. Hans Rees' was a New York corporation engaged in the business of tanning, manufacturing and selling leather. The taxpayer had a manufacturing plant located in North Carolina. Its sales office was located in New York. Sales were made throughout the United States and abroad. Some sales were also made in North Carolina. Hans Rees' established that the income from its business was derived from three sources: (1) buying profit, (2) manufacturing profit, and (3) selling profit. The record also established that for the years in issue, the average income with its source in the manufacturing and tanning operations within North Carolina was 17 percent. The state of North Carolina had, pursuant to its statutory method, for the years in question assessed between 66 and 85 percent of Hans Rees' income to the state. This Court was of the opinion that, when a corporation manufactures in one state and sells in another, the net profits of the entire transaction, as a unitary business, could not be attributed, *regardless of the evidence,* to either state. In elaborating on this position this Court stated:

> "Undoubtedly the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent, and hence, when the state has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire income may be taxed in one state regardless of the extent to which it may be derived from the conduct of the enterprise in another state. As was said in the Bass Case with regard to 'the unitary business of manufacturing and selling ale' which began with manufacturing in England and ended in sales in New York, that state 'was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business.' And the principle that was recognized in National Leather Company v. Massachusetts, supra, was that a tax could lawfully be imposed upon a foreign corporation with respect to 'the proportionate part of its total net income which was at-

> tributable to the business carried on within the State.' When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a state has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction.'' (283 U.S. at 133-34).

From the above quote, it is obvious that this Court rejected the application of a unitary concept which enables one state to tax the entire income of a multistate corporation without regard to the extent to which that income may be derived from business conducted in another state.

In *Butler Brothers* v. *McColgan, supra,* the taxpayer contested an assessment under the California Franchise Tax, which is assessed against a corporation's net income as attributed to the state by an apportionment formula. Butler Brothers was an Illinois corporation qualified to do business in California with its home office in Chicago, Illinois, and it was engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and selling to retailers. It maintained a wholesale distributing house in California and all receipts from sales in California were credited to the San Francisco house for the period in question by deducting from the gross sales receipts in California, the cost of such merchandise, the direct expense of the San Francisco house and the indirect expense allocated to it. This resulted in a loss. The California Tax Commissioner, utilizing an apportionment formula consisting of property, wages, and sales, allocated 8.1 percent of Butler Brothers' total corporate net income to California. The taxpayer contended that by use of this formula California had converted a substantial loss into a profit, and that the difference had either been created out

of nothing or had been apportioned by California from other states. This Court did not accept Butler Brothers' position. In finding that Butler Brothers was a unitary business, relying primarily on *Hans Rees'* and *Bass, Ratcliff,* and in affirming the tax imposed by California, this Court stated:

> ''One who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extraterritorial values being taxed. See Norfolk & Western Ry. Co. v. North Carolina, 297 U.S. 682, 688, 56 S.Ct. 625, 628, 80 L. Ed. 977. This court held in Hans Rees' Sons, Inc. v. North Carolina, supra, 283 U.S. page 135, 51 S.Ct. page 387, 75 L. Ed. 879, that that burden had been maintained on a showing by the taxpayer that 'in any aspect of the evidence' its income attributable to North Carolina was 'out of all appropriate proportion to the business' transacted by the taxpayer in that State. No such showing has been made here.'' (315 U.S. at 507).

This Court went on to stress that Butler Brothers had not shown the precise sources of its net income, and had not shown any factors responsible for that income being earned in states other than California. It was also emphasized that no showing had been made that income unconnected with the unitary business had been included in the formula by California.

This Court's most recent opinion regarding state taxation of an interstate business by means of an apportionment formula was rendered in *Moorman Manufacturing Co.* v. *Bair,* 437 U.S. 267, 98 S.Ct. 2340 (1978). Moorman, an Illinois corporation, was engaged in the manufacturing and sale of animal feeds. It sold products to Iowa customers through salesmen and from warehouses in the state. All of the product was manufactured in Illinois. The Iowa apportionment formula is a single-factor formu-

ia utilizing sales. Under the Iowa statute the income attributable to Iowa is determined by first eliminating income allocable to other states. From the remaining income, that attributable to business done in Iowa is calculated by taking that proportion of the gross sales made within the state to total gross sales. Moorman challenged the constitutionality of the Iowa single factor formula, and the trial court held the formula invalid under the Due Process and Commerce Clauses of the United States Constitution. The Supreme Court of Iowa reversed, and the case then came before this Court. This Court, in responding to Moorman's contention that Iowa's single factor formula resulted in the taxation of extraterritorial income in violation of the Due Process Clause, stated:

> "Appellant does not suggest that it has shown that a significant portion of the income attributed to Iowa in fact was generated by its Illinois operations; the record does not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations." (437 U.S. at 272).

Further on in its opinion this Court stated:

> "The Iowa statute afforded appellant an opportunity to demonstrate that the single-factor formula produced an arbitrary result in its case. But this record contains no such showing and therefore the Director's assessment is not subject to challenge under the Due Process Clause." (437 U.S. at 275). (Footnote omitted).

In the above quotes from *Moorman,* this Court has set forth the framework necessary to establish a Due Process violation for a multistate business challenging a state's apportionment formula. *Moorman* thus acknowledges that separate functional accounting may be used by a taxpayer to identify the income or profits from the various phases or functions of the company's operations and thereby es-

tablish that the income attributed to a given state is "out of all appropriate proportion to the business transacted . . . in that state." *Hans Rees' Sons, supra,* 283 U.S. at 135. It should be noted that the South Carolina courts rejected this functional accounting approach by stating that, despite expert testimony, transfer pricing, as opposed to sales to third parties, "cannot be used by a multi-state corporation in computing divisional income," thus ignoring this Court's prescription for finding a Due Process violation. In the record before this Court in *Moorman,* appellant made no attempt to establish the profits or income of its manufacturing operation in Illinois, and without such a record this Court could not find that Iowa had taxed extraterritorial income.

In the present case Appellant has done exactly what this Court indicated should have been done in *Moorman* in order to establish the taxation of extraterritorial income. By separate functional accounting, Appellant has shown the net income for all three of its functional operations. In Schedule A, see Appendix G at p. App. 51, Appellant set forth, for the years in issue, its taxable income and tax for each year if apportionment is used for its Marketing function, and for its Marketing and Refining functions; and its taxable income and tax if its Exploration and Production function is treated as a separate segment with income allocated to situs. This schedule shows that there is a spread of approximately 24.6 million dollars between the income taxable by South Carolina if Exploration and Production income is allocated to situs and that income which the State has pulled in and taxed under its apportionment method.

In addition, the testimony of Appellant's witnesses established that Appellant's operational departments were conducted and were accounted for as separate functions of its total enterprise and that the Exploration and Pro-

duction Department income was all earned outside of South Carolina from activities outside South Carolina. The Tax Commission's only "evidence" in opposition concerned the *possible* tracing of gasoline from Appellant's Baytown, Texas refinery to the Charleston, South Carolina port. To the extent this evidence shows anything, it merely proves that there is a refinery operational buffer between the Exploration and Production Department and Appellant's South Carolina marketing. Understandably, this "evidence" was deleted by the South Carolina Supreme Court in its adoption of the trial court's opinion. By separate functional accounting Appellant has proven that extraterritorial income (from Exploration and Production operations) has been included in the South Carolina apportionment formula, thus resulting in a Due Process Clause violation.

Therefore, within the framework established by this Court in *Bass, Ratcliff, Hans Rees', Butler Brothers* and *Moorman,* the decision of the South Carolina Supreme Court and its all encompassing unitary concept cannot stand. None of these decisions has permitted a finding of "unitary" to ignore situs income realities. A finding of unitary at the very most presents merely a condition precedent to the right to apply an apportionment formula to the income of that so-called unitary business, providing that the taxpayer is unable to show either that all or part of that income is not subject to taxation as not being attributable to business done in the state, or that the resulting tax may be out of all proportion to business conducted in the state. In *Bass, Ratcliff, Butler Brothers* and *Moorman* the taxpayer's proof was not sufficient to overcome the condition precedent. However, in *Hans Rees'* it was, and this Court struck down North Carolina's method of taxation as unconstitutional. The opinion of the

South Carolina Supreme Court has even less constitutional validity when the facts in *Bass, Ratcliff, Hans Rees', Butler Brothers* and *Moorman* are compared to those in the present case.

Bass, Ratcliff, Hans Rees' and *Moorman* involved businesses engaged in manufacturing and selling, and *Butler Brothers* was a business engaged in purchasing and selling. None of these cases concerned a vertically integrated petroleum company operating under the principle of functional profitability independence, as is more specifically described above in the Statement of the Case. Appellant's structure, with its separate internal functional accounting, makes the use of the unitary concept as expressed by the South Carolina Supreme Court wholly indefensible under this Court's decisions.

II. THE ASSESSMENT OF SOUTH CAROLINA TAX ON INCOME DERIVED FROM APPELLANT'S EXPLORATION AND PRODUCTION FUNCTIONAL OPERATIONS OUTSIDE THE STATE CONSTITUTES A CONSTRUCTION OF S.C. CODE §§12-7-250 and 12-7-1130 WHICH VIOLATES THE DUE PROCESS CLAUSE OF THE FOURTEENTH AMENDMENT TO THE UNITED STATES CONSTITUTION.

In the trial record Appellant established that, pursuant to its accounting practices and those of the industry, all of the income of its Exploration and Production Department was calculated from third party sales of natural gas, from actual transfers of crude oil to third parties at posted field prices or from internal transfers between its Exploration and Production Department and its Refining Department based upon the arms length posted field prices utilized in the industry. The record established that the

crude oil that went to Appellant's refineries was produced outside South Carolina and was transferred outside South Carolina. The Exploration and Production income, therefore, was derived at the situs of the Exploration and Production activities and, under S.C. Code §§12-7-250 and 12-7-1130 had to be so allocated, and not apportioned, as all such activities occurred outside of South Carolina.

This Court held in *National Bellas Hess, Inc.* v. *Department of Revenue,* 386 U.S. 753, 87 S.Ct. 1389 (1967), that a state may not impose a tax unless there is some minimum connection between the activities of the taxpayer in the state and the taxing state. In subjecting virtually all of Appellant's Exploration and Production income to apportionment by South Carolina, the South Carolina Supreme Court has ignored this nexus requirement. There are no Exploration and Production activities in South Carolina, so there can be no connection between such activities and the State. South Carolina attempts to obscure this nexus requirement by arguing that Appellant has much activity in the state and placing special emphasis upon Appellant's "massive facility" at Charleston. The marketing activities of Appellant in South Carolina, which include the Charleston facility, are not disputed and have no relevance to the constitutionality of taxing Exploration and Development situs income in a state which has no connection with any Exploration and Production Department activities.

Appellant is aware of no decisions of this Court involving the application of an apportionment formula to situs income earned outside the taxing state. The general prohibition set forth in *Hans Rees'* should be controlling to prevent the taxation of such situs income, as it otherwise results in unreasonably and arbitrarily attributing to South Carolina "a percentage of income all out of appropriate proportion to business transacted by the appellant in that state." (283 U.S. at 135-36).

The South Carolina courts placed almost sole reliance upon the case of *Butler Brothers* v. *McColgan, supra.* This exclusive reliance upon *Butler Brothers* was to the derogation of *Hans Rees' Sons* v. *North Carolina, supra.* These cases are different both factually and as regards the issues they address. As stated above, the *Butler Brothers* case involved an attack upon the California formula of apportionment while *Hans Rees'* dealt more directly with the problem of taxing income without regard to evidence which clearly placed that income in another state. After attempting, with obvious lack of success, to distinguish the *Hans Rees'* case, the South Carolina courts simply concluded arbitrarily that, in any event, *Butler Brothers* should control the instant matters since it was the later of the two cases. (App. A, at p. App. 12)

It is the position of the Appellant that *Butler Brothers* is distinguishable from the present case since Appellant does not contest the reasonableness of the formula used upon income shown to be derived from a "unitary business," or in other words, from a multistate corporation whose state by state marketing income is difficult to determine. To the extent that certain language in the *Butler Brothers* opinion regarding the recognition of separate accounting systems in determining state income of a multistate corporation appears troublesome, this Court's recent opinion in *Moorman Manufacturing Co.* v. *Bair, supra,* should be consulted. In footnote 9 of the *Moorman* opinion, this Court quoted with approval the following language from a concurring opinion in the Iowa Supreme Court:

> "In this era of sophisticated accounting techniques, it should not be impossible for a unitary corporation to prove its actual income from activities in a particular state." (437 U.S. at 275).

This quotation, together with the quotation in Part I above from the *Moorman* case, clearly show the distinction be-

tween the unacceptable accounting approach rejected in *Butler Brothers* and the acceptable accounting approach delineated in *Moorman.* In *Butler Brothers,* the Appellant attempted to justify its loss for purposes of California state taxation by employing a method of geographical accounting which purported to break down the income of a single function company on a state by state basis. Given the difficulties of identifying the various cost and income factors of a single function company on this geographical basis, the Court in *Butler Brothers* found no constitutional problem with California's rejection of such an accounting system. In *Moorman,* however, the court specifically states that a multistate company which is also a multi-function company can utilize a functional separate accounting approach which is able to specifically identify the income from a particular function and allocate that income to the state in which that function is carried out. Thus, the separate functional accounting presented by Appellant here which identifies the Exploration and Production situs income has been authorized and approved by this Court in the *Moorman* decision. This accounting clearly shows that extraterritorial income is being taxed by the state of South Carolina.

Regarding the position of the South Carolina courts that Appellant's accounting techniques are somehow flawed by their reliance upon unrealized income or, as stated below, "transfer pricing rather than sales to third parties," (App. A at p. App. 10) it is clear that the South Carolina courts have created an arbitrary distinction. In essence what the South Carolina Supreme Court has done is to make a distinction between "realized" income, *i.e.,* that resulting from sales to third parties, and "unrealized" income, *i.e.,* transferred internally at posted field prices.

Certainly no such distinction has ever been made by this Court. Indeed, this Court has never recognized that only

"realized" income can be used for determining taxable income. On the contrary this Court has used such words as "attributable to" (*Hans Rees'*), "derived" (*Butler Brothers*) and "earned" (*Moorman*) to describe taxable income. In short, the South Carolina Supreme Court cannot, upon the pretext of questioning Appellant's accounting integrity, attempt to avoid the constitutional prohibition against taxing income that has no reasonable relationship to the taxing state. A repeat of a quote already set forth in Point I, *supra,* is most appropriate to the present situation.

> "But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purposes of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one state regardless of the extent from which it may derive from the conduct of the enterprise in another state." (*Hans Rees', supra,* 283 U.S. at 133).

By refusing to exclude from apportionable income the situs income from Appellant's Exploration and Production Department, the South Carolina Supreme Court has rendered §§ 12-7-250 and 12-7-1130 unconstitutional under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

III. THE ASSESSMENT OF SOUTH CAROLINA TAX ON INCOME DERIVED FROM APPELLANT'S EXPLORATION AND PRODUCTION FUNCTIONAL OPERATIONS OUTSIDE THE STATE CONSTITUTES A CONSTRUCTION OF S.C. CODE §§12-7-250 and 12-7-1130 WHICH VIOLATES THE COMMERCE CLAUSE OF ARTICLE ONE OF THE UNITED STATES CONSTITUTION.

Since 1920 there has been a series of cases which have held that all oil and gas production income was taxable in the producing states. *Shaffer* v. *Carter,* 252 U.S. 37, 40 S.Ct. 221 (1920); *Magnolia Petroleum Co.* v. *Oklahoma Tax Commission,* 190 Okla. 172, 121 P.2d 1008 (1942); *Texas Company* v. *Cooper,* 236 La. 380, 107 So.2d 676 (1959); *Webb Resources* v. *McCoy,* 194 Kan. 758, 401 P.2d 879 (1965). As reflected by these cases, the jurisdiction where the extraction activity occurs has the power to impose an income tax on Appellant's Exploration and Production income. Where other states such as South Carolina also impose a tax, this results in multiple taxation of that income and constitutes a burden on interstate commerce in violation of the Commerce Clause of the United States Constitution.

The South Carolina courts rejected the arguments of Appellant that it was being subjected to multiple taxation. Stating that "the prevention of double taxation is, of course, the whole reason for apportioning income," (App. A at p. App. 14) the South Carolina opinion noted that between 1% and 1.2% of Appellant's overall income in the years in question had been allocated to South Carolina and that the record did not disclose what portion of Appellant's total income was taxed by all states combined and whether or not that exceeded 100%.

The compelled inference from the foregoing is that multiple taxation as a burden on interstate commerce in violation of the Commerce Clause of the United States Constitution occurs only if a situs state having the power to tax situs operations actually exercises that power. This utterly ignores the basic proposition that a violation of the Commerce Clause occurs if a state, South Carolina in this case, imposes a tax on the situs income derived in the situs state if that situs state has the power to impose a tax on such income, regardless of whether or not that power is exercised; *Standard Pressed Steel Co.* v. *Washington,* 419 U.S. 560, 95 S.Ct. 706 (1975); *General Motors Corporation* v. *Washington,* 377 U.S. 436, 84 S.Ct. 1564 (1964). Thus, by any test, the South Carolina Supreme Court in this case chose to ignore the true strictures of multiple taxation as a burden on interstate commerce. This erroneous conclusion of the South Carolina Supreme Court is further underscored, both in terms of a violation of the Commerce Clause as well as of the Due Process Clause, by its irrelevant reference to the "massive" Charleston facility and other "substantial" South Carolina activities. All of these activities involved Appellant's Marketing Department and the income from those activities was included in the South Carolina apportionable income in Appellant's filed returns. South Carolina thus, justifies its attempt to tax the entire corporate income of Appellant on some sort of "fair share" theory without regard to the constitutional proscription against taxing those activities carried on by a multistate corporation which have no relation to the State of South Carolina.

In *Moorman,* the taxpayer also claimed that there was a violation of the Commerce Clause in that both Iowa and Illinois imposed a tax on the income derived from Iowa sales. The taxpayer argued that this was brought about by Iowa's use of the single-factor formula and Illinois'

use of the more common three factor formula. This Court did not agree that there had been a Commerce Clause violation, stating:

> "Since appellant did not prove the portion derived from sales to Iowa customers, rather than sales to customers in other States, we do not know whether Illinois and Iowa together imposed a tax on more than 100% of the relevant net income." (437 U.S. at 276).

This Court also stressed that:

> "Since the record does not reveal the sources of appellant's profits, its Commerce Clause claim cannot rest on the premise that profits earned in Illinois were included in its Iowa taxable income and therefore the Iowa formula was at fault for whatever overlap may have existed." (437 U.S. at 277).

In the present record before this Court, Appellant has established that the sources of income derived from its Exploration and Production operations were all in states *other* than South Carolina. Consequently, the South Carolina apportionment formula clearly includes income from out-of-state sources by encompassing income from Appellant's Exploration and Production operations, and is therefore in violation of the Commerce Clause of the United States Constitution.

Finally, the South Carolina Supreme Court, by using a unitary concept which subjects to apportionment virtually all of Appellant's total corporate income without regard to any meaningful relationship of the Exploration and Production activities of Appellant to Appellant's South Carolina marketing activities, causes multiple taxation as an obvious and automatic end result of such a concept, and thereby places a burden on interstate commerce in violation of the Commerce Clause of the United States Constitution.

IV. WITH THE SOUTH CAROLINA SUPREME COURT'S DECISION HEREIN, A CONFLICT HAS ARISEN BETWEEN BOTH THE HIGHEST COURTS OF VARIOUS STATES AND WITH A FEDERAL CIRCUIT COURT OF APPEALS IN THE TREATMENT OF EXPLORATION AND PRODUCTION INCOME OF AN OIL AND GAS COMPANY.

The present decision by the South Carolina Supreme Court to include Appellant's Exploration and Production income in the South Carolina apportionment formula, presents a direct conflict with the decisions of five state supreme courts and one federal court of appeals.

The Minnesota Supreme Court in *Skelly Oil Company* v. *Commissioner of Taxation,* 269 Minn. 351, 131 N.W.2d 632 (1964), concluded that the exploration and production, refining and marketing functions of Skelly were operated as separate businesses. Further, it was concluded that because posted field prices were competitively established, were employed for federal depletion, severance tax, production states' income tax and royalty payment purposes, and were utilized as the prices for which the taxpayer bought and sold crude oil, they constituted a bona fide base for internal transfer pricing from production to refining. Adding this all together, the Minnesota Supreme Court held that only marketing income was exposed to taxation, this being the only function being carried on in Minnesota, and that the unitary concept was inapplicable. The Court concluded that:

> "Skelly's sole activity in Minnesota is the marketing of finished products, as the proof clearly shows. The only permissible conclusion is that taxes based on the inclusion of production income, no matter what the percentage, in apportionable income are beyond the state's authority. Minnesota may include in the apportionable income subject to its tax only income at-

tributable to Skelly's marketing activity." (131 N.W.2d at 646).

In *Tenneco, Inc.* v. *Barr,* 224 So.2d 208 (Miss. 1969), the taxpayer operated a gas transmission system, part of which was situated in Mississippi and a gas exploration and production function carried on outside Mississippi. The former was operated at a profit and the latter at a loss, so the taxpayer sought total apportionment on the unitary theory, which the Mississippi Tax Commission opposed. The Mississippi Supreme Court held the transmission business alone to be unitary and subject to apportionment, but that the gas exploration and production operations were not unitary with or an integral part of the transmission operations, and hence, separate accounting applied to those functions.

The Circuit Court of Appeals of the Eighth Circuit, in *Standard Oil Co.* v. *Thoresen,* 29 F.2d 708 (8th Cir. 1928), held that under the law of North Dakota the plaintiff oil company was *not* required to pay North Dakota taxes on its producing and refining oil business done only in other states simply because it engaged in the business of marketing refined products in North Dakota. The Eighth Circuit was of the opinion that any statute of a state which attempted to tax income from property located in another state was void as being beyond the power of the taxing state.

Furthermore, the supreme courts of three situs states, where there was oil and gas production, have held that the income from oil and gas production was allocable to situs and taxable in each respective producing state, regardless of whether or not the taxpayer corporation was unitary or whether the income was actually realized or was derived from a fair market value computation. *Magnolia Petroleum Co.* v. *Oklahoma Tax Commission, supra; Texas Company* v. *Cooper, supra; Webb Resources* v. *McCoy, supra.*

Thus, the decision of the South Carolina Supreme Court is completely contrary to the decisions in *Skelly, Tenneco,*

Standard Oil, Magnolia, Texas Company and *Webb Resources,* and this creates the type of split of authority which this Court should resolve.

CONCLUSION

This case presents the factual record on the Due Process Clause challenge which this Court found lacking in *Moorman,* as well as in *Butler Brothers.* Thus, it presents this Court with the basis to delineate the limits of constitutionally permissible state apportionment of income from a multistate taxpayer's activities conducted outside the taxing state. The use of the unitary approach to reach extraterritorial income in the South Carolina Supreme Court's decision presents a question of first impression, and the factual record shows taxation of income out of all appropriate proportion to the activties of the Appellant in South Carolina with a resulting burden on interstate commerce. Also, because this decision stands at complete odds with the decisions of other state supreme courts and of a lower federal court, this appeal presents this Court with the opportunity of resolving this split of authorities.

For the foregoing reasons it is respectfully requested that probable jurisdiction be noted.

Respectfully submitted,

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APPENDIX

APPENDIX A

THE STATE OF SOUTH CAROLINA
In The Supreme Court

Exxon Corporation, ... Appellant,

v.

South Carolina Tax Commission, ... Respondent.

Appeal From Richland County
Joseph R. Moss, Special Circuit Court Judge

Opinion No. 21049

Filed September 5, 1979

AFFIRMED

Charles W. Knowlton, J. Donald Dial, Jr., and George S. King, Jr., all of Boyd, Knowlton, Tate & Finlay, of Columbia; Lloyd M. McBride and Paul D. Frenz, both of McBride, Baker, Wienke & Schlosser, of Chicago, Illinois; and Joseph O. Luby, Jr., of EXXON, U.S.A., of Houston, Texas, for appellant.

Attorney General Daniel R. McLeod, Deputy Attorney General
Joe L. Allen, Jr., Senior Assistant Attorney General
G. Lewis Argoe, Jr., and Assistant Attorney General
John C. von Lehe, all of Columbia, for respondent.

PER CURIAM: We are of the opinion that the order of Judge Moss properly sets forth and disposes of all issues raised by this appeal. His order, with deletions as indicated, will be printed as the opinion of this court. The matters included in brackets are our own.

ORDER OF HONORABLE JOSEPH R. MOSS

This action was brought pursuant to Section 12-47-220 for a refund of $1,720,718.10 income taxes with interest paid under protest. The taxes were assessed on income generated by Humble Oil and Refining Company (Humble). During the years in question, 1970, 1971 and 1972, Humble was a wholly-owned subsidiary of Standard Oil Company of New Jersey (Standard Oil). Standard Oil was an international petroleum company. In contrast to its parent, Humble's activities were primarily domestic. It was engaged in the exploration and production of crude oil and natural gas, in the refining of crude oil and in the sale of petroleum products. Such a combination of activities is often referred to as vertical integration. Humble operated in this State under the trade name of Esso. The present corporate structure came about after the years in question when Humble was merged into Standard Oil which had changed its name to Exxon.

For the years in question, Humble reported its income to this State under a method which excluded from the tax base that portion of its corporate income assigned by the company to its exploration and production activities. Humble reported its income as follows:

	A	B	A - B (with adjustments)
	Net Income of the Corporation	Assigned to Exploration and Production	Income to Which S. C. Ratio Applied
1970	$573,910,020	$474,486,034	$ 75,399,694
1971	679,525,217	533,854,718	110,123,128
1972	624,911,477	549,259,522	34,647,726

On audit the exclusion of the amount assigned to exploration and production activities was disallowed and Humble's liability was computed by applying the South Carolina apportionment ratio to the net income of the corporation less certain minor items which were specifically allocated. The basic question is therefore whether or not the Tax Commission acted properly in applying the apportionment ratio to Humble's corporate income in arriving at a tax base, or whether the ratio should have been applied, as the plaintiff contends, to a lesser amount derived by excluding that portion assigned by Humble to its exploration and production activities. In my opinion the method employed by the defendant Tax Commission is in accordance with the income tax laws of this State and does not violate any constitutional provision. For the reasons which follow, I have determined that the tax in question was properly assessed and collected and that no refund should be granted.

The taxes in question are imposed by Sections 12-7-230 and 12-7-250 of the 1976 South Carolina Code of Laws. Section 12-7-250 states:

> "If a taxpayer * * * is transacting or conducting his business partly within and partly without this State, the income tax * * * shall be imposed upon a base which reasonably represents the portion of the trade or business carried on within this State."

A taxpayer may, of course, operate more than one business. If a single corporation operates two or more "unrelated businesses" within its corporate shell, the Tax Commission seeks to apportion and tax only the income from the business that operates in this State. The Commission Regulation follows:

> "117-87.17 UNRELATED BUSINESS — The phrase 'transacting or conducting his business partly within and partly without the State of South Carolina' * * *, is applicable to a single business operation, which is unitary or homogenous and is carried on both within and without the State. * * *. A Taxpayer operating a unitary or homogenous business within and without the State and an unrelated business either entirely within or without shall be subject to the allocation formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. The income from the unrelated business shall be directly assignable to the state where such business is conducted."

Humble argues that its exploration and production activities comprise an "unrelated business" and that the income allocated by it to those activities should be directly assigned to the states where such activities are conducted. The defendant Tax Commission on the other hand contends that Humble's exploration and production activities are a part of the company's "single business operation which is unitary" and has therefore refused to allow the plaintiff to reduce its apportionable income by the amount assigned by Humble to its exploration and production activities.

The leading case on the meaning of the term "unitary" as it is used in the area of state taxation of multistate businesses is *Butler Brothers* v. *McColgan,* 315 U. S. 501, 62 S. Ct. 701. The concept applied in the *Butler Brothers* decision has become known as the "unities" definition. The Supreme Court spoke of "unity of use and management". The California decision which it was affirming had used as its definition unity of ownership, unity of management and unity of operation. See *Butler Brothers* v. *McColgan,* 17 Cal. 2d 664, 111 P. 2d 334 (1942).

In the Supreme Court decision (pages 509 U. S. and 705 S. Ct.), the Court spoke of the "contribution" of the California operations to the business as a whole. It had already addressed the benefits derived by the California operation from the company's business without the state. This interaction of contribution and/or dependence has evolved into the "contribution-dependence" definition which has been used by nearly all state courts that have considered the question of whether or not a business is unitary. Among the states applying the contribution-dependence test are Kansas, Minnesota, Montana, Oklahoma, Oregon, Utah, Virginia and Wisconsin. * * * *

The "unities" concept and the "contribution-dependence" test are by no means mutually exclusive. In the decision cited above, the courts have often applied both definitions in deciding whether or not a business is unitary in nature. The origins of both definitions may be traced to the *Butler Brothers* decision and the activities of a corporation which exhibit unity of ownership, management and operation have usually been found to be activities which are contributory or dependent upon one another.

The South Carolina Supreme Court has not been faced with the question of whether or not a particular business is unitary in nature. A recent case has, however, commented on the term. In *Covington Fabrics* v. *South Carolina Tax Commission,* 264 S. C. 59, 212 S. E. 2d 574, appeal dismissed 96 S. Ct. 14 (1975), our Court said:

> "It is conceded that the business is unitary in nature, therefore its income is attributable to all incidents of the business and not to any single activity."

The Court then quoted a portion, but not all, of the definition used by the North Carolina Court in *State Ex Rel. Maxwell* v. *Kent Coffey Manufacturing Co.*, 204 N. C. 365, 168 S. E. 397, affirmed 54 S. Ct. 437 (1933).

> "That term (unitary) is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of business—a business the component parts of which are too closely connected and necessary to each other to justify division or separate consideration, as independent units."

The South Carolina Court did not quote the additional language of the decision which is relied on by Humble, i.e., whether or not the activities sought to be separated are "capable of producing a profit in and of themselves". We did not adopt as our definition the language that the activities of a business are not unitary if they "might be maintained as an independent business (however convenient and profitable it may be to operate them cojointly)". This language lends itself to a definition of unitary in terms of essentiality. Following such a definiiton, tests of contribution or dependence as well as unity of ownership, management and operation would be irrelevant. In my opinion, a definition of unitary based on whether or not the segments sought to be separated are essential to one another so that one could not be operated without the other, no matter what benefits in the form of cost savings or additional revenues are lost by the separation, is not in conformity with the *Butler Brothers* decision. A California Supreme Court case is directly on point. In *Superior Oil Company* v. *Franchise Tax Board*, 34 Cal. Rptr. 545, 386 P. 2d 33 (1963), the tax collector wanted to separate the company's California production operations and not treat the company as a unitary business. *Superior* was primarily a producing company with wells in California and other states. It refined only a

minor portion of its production and most of *Superior's* crude was sold at the wellhead. The Court held that the company operated a "unitary business" as that term is defined in the *Butler Brothers* case, i.e., (1) unity of ownership, (2) unity of operation and, (3) unity of use. It then quoted the contribution-dependence test. The Court went on to specifically reject the "necessary and essential" test now proposed by Humble. In describing the *Butler Brothers* rule, it said:

> "In (the Supreme Court's) view the test was not one based on essential activities but rather one based on contributing activities * * *."

In my opinion, the proper answer to the question of whether or not a business is unitary in nature is given in terms of whether or not the business possesses the characteristics of unity of ownership, unity of management and unity of operation and whether or not the activities of the business in question contribute to or depend on the other activities of the business.

[Here Judge Moss sets forth in detail a factual analysis of the overall operations of Humble, particularly as related to the interdependence of its several departments. His findings of fact from such analysis are recapitulated below.]

A recapitulation of the facts concerning Humble is: (1) Humble held itself out to the public as one company. It made no attempt to externally identify its exploration and production activities as a separate business. (2) The company employed central staff services upon which all departments were dependent. (3) Humble used centralized purchasing techniques which produced savings throughout the company. (4) Strong centralized management was employed over all segments of the company.

(5) The combination of the various activities within a single corporation was beneficial to Humble in that it provided profit stability, reduced risk and insured full capacity utilization of the company's facilities. (6) Humble's crude production and crude sales made crude purchases available for its refineries. (7) High-level personnel within the various departments were selected by upper management, not by departmental vice presidents, and the movement of personnel throughout the company was a beneficial practice employed by Humble. The combination of the various functions created a pool or source of talent which otherwise would not have been available. (8) A central source of earnings and funds was employed and no attempt was made to segregate accumulated earnings or funds based on the company's internal assignment or earnings to these functions. (9) Based on the company's internal assignment of earnings and assets to the various functions, refining and marketing were dependent upon the company as a whole during the years in question. Had the functions not been combined, an additional cost of capital would have existed because of the necessity for borrowed funds. This cost was averted because of the vertical integration of the company. (10) The various operating activities of exploration and production, refining and marketing both contributed to and depended on each other.

In my opinion Humble, during the years in question, was a single unitary business comprised of the exploration and production of crude oil and natural gas, the refining of crude oil and the marketing of natural gas and refined petroleum products. The corporation possessed the characteristics of unity of ownership, unity of management and unity of operation, and the activities of E & P, refining and marketing all contributed to and depended upon each other.

SOUTH CAROLINA ACTIVITIES

Humble's gasoline and oil were sold in this State during the years in question under the trade name "Esso", a name which the company or its predecessors had used here for over thirty (30) continuous years. Humble had approximately thirteen hundred (1,300) gasoline stations in this State, many of which were uniformly designed and constructed by the company in order to promote the sale of its branded gasoline.

Gasoline came into South Carolina from two sources, pipeline and tanker. Humble's tankers continuously used the port of Charleston. At Charleston the company owned and operated a massive facility described as a "terminal". This "terminal" included a product blending operation, a motor oil canning facility and an asphalt plant. The terminal was housed on approximately one hundred ninety (190) contiguous acres of land. (Photographs of the facility are in the record.) Additionally, Humble owned and occupied at Charleston about twenty (20) other lots or parcels of improved realty. Products blended and canned at the Charleston terminal were distributed and sold in neighboring states.

* * * * * *

Having found that the major operating activities of Humble, consisting of E & P, refining and marketing, constituted one unitary business, [and that Humble's South Carolina activities during the years in question were substantial] it is next necessary to examine the plaintiff's other contentions. The plaintiff has argued that extraterritorial values are being reached and that because of severance taxes levied by numerous oil producing states it is being subjected to multiple taxation.

With regard to the overreach allegation which raises arguments based both on the Due Process Clause and the Commerce Clause of the United States Constitution, our Court stated in the *Covington Fabrics* decision, supra:

> "We have not found a case that supports the corporation's contention that the application of a three factor formula unreasonably apportions income, nor has one been called to our attention. The formula has however been considered and approved as a reasonable basis for apportioning income. The Supreme Court of the United States, in the case of Butler Bros. v. McColgan, supra, held that:
>
> > 'We cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors *may properly be deemed to reflect "the relative contribution of the activities in the various states to the production of the total unitary income,"* so as to allocate to California its just proportion of the profits earned by the appellant from this unitary business.' (Emphasis added.)"

As stated earlier, Humble transferred a majority of its crude (both produced and purchased) to its refineries. The income computed for E & P was therefore based primarily on transfer prices rather than on actual sales to third parties. This transfer pricing was referred to by Humble's expert accounting witness as "unrealized income". He stated that he would not give an unqualified opinion as to the accuracy of the exploration and production income because the sales were not made to third parties. The defendant Tax Commission has cited authority from the Georgia courts which holds that the transfer pricing rather than sales to third parties cannot be used by a multistate corporation in computing divi-

sional income. See *Phillips* v. *Sinclair Refining Co.*, 44 S. E. 2d 671 (Ga. 1947). I find the reasoning of the Georgia case persuasive. It is in line with the conclusion reached by the United States Supreme Court in *Bass, Ratcliff & Gretton* v. *State Tax Commission,* 266 U. S. 271, 45 S. Ct. 82, which held that the unitary business in question there earned no profits until actual sales of its products were made. See also *Northwestern States Portland Cement Co.* v. *Minnesota,* 358 U. S. 450, 79 S. Ct. 357, which quotes the same language at page 461 U. S. and 363 S. Ct. Reports. However, under the *Butler Brothers* decision, it is not necessary to impeach Humble's accounting system. The Court stated:

> "It is true that appellant's separate accounting system for its San Francisco branch attributed no net income to California. But we need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed. Accounting pratices for income statements may vary considerably according to the problem at hand. * * *. A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders. * * *."

The plaintiff has placed strong reliance on the case of *Hans Rees' Sons, Inc.* v. *North Carolina,* 283 U. S. 123, 51 S. Ct. 385, decided in 1931, ten years prior to the *Butler Brothers* decision. In *Hans Rees* the Supreme Court reversed a decision of the North Carolina Court which had refused to allow the introduction into evidence of proof of the multistate business's earnings in that state. The corporation's activities in North Carolina consisted of manufacturing and the state's archaic income tax apportionment formula which utilized only a single property factor had apportioned over eighty (80%) percent of the company's income there in three years of the four in question. The

company had offered evidence to show that only seventeen (17%) percent of its income was earned in North Carolina. The Court stated of the formula applied:

> "For the present purpose, in determining the validity of the statutory method as applied to the appellant, it is not necessary to review the evidence in detail, or to determine as a matter of fact the precise part of the income which should be regarded as attributable to the business conducted in North Carolina. It is sufficient to say that, in any aspect of the evidence, and upon the assumption made by the state court with respect to the facts shown, the statutory method, as applied to the appellant's business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state. In this view, the taxes laid were beyond the state's authority. * * *."

The *Hans Rees* decision may be distinguished from the later *Butler Brothers* case on the ground that the California formula of property, payroll and sales more accurately measured the contribution of *Butler Brothers'* California activities to the corporation's unitary income. South Carolina has employed a formula based on these three principles. If *Hans Rees* cannot be distinguished from *Butler Brothers,* the later decision of course controls.

The plaintiff has also relied on the Minnesota decision of *Skelly Oil Company* v. *Commissioner,* 269 Minn. 351, 131 N. W. 2d 632 (1964). I do not find that case persuasive. It is not, in my opinion, in line with the *Butler Brothers* case or the great weight of authority throughout the country which has stemmed from the *Butler Brothers* decision. The *Skelly* decision is perhaps distinguishable based on the fact that *Skelly* proved that only nine (9%) percent of the crude oil it produced was used in its re-

fineries thereby giving the Minnesota Court at least some basis upon which to affirm the Lower Court's fact finding that the production activities of the corporation formed a business that was separate from the refining and marketing functions. Furthermore, the interdependence found to be lacking in *Skelly* was present in Humble. In *Skelly,* the Lower Court had found that decisions about exploration and production, such as where, when and in what volume the oil was to be produced, were decided entirely by the departments in charge of those activities without regard to the needs of *Skelly's* refineries or markets. Based on the record before me, this was certainly not the case with Humble. Also, *Skelly* apparently had no supply department because no need existed to coordinate its production department with the rest of the company. Such a need obviously existed at Humble.

A court's primary concern in the due process area is not to improvise a method for computing taxes, but to inquire as to whether or not the method provided imposes a tax which bears a reasonable relationship to the taxpayer's activities in this State. As stated in the case of *Wisconsin* v. *J. C. Penney Co.,* 311 U. S. 435, 61 S. Ct. 246, page 250 (1940):

> "* * *. That test (due process) is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return. The substantial privilege of carrying on business in Wisconsin, which has here been given, clearly supports the tax, and the state has not given the less merely because it has conditioned the demand of the exaction upon happenings outside its own borders. The fact that a

> tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction. * * *."

The South Carolina activities of Humble were substantial particularly when viewed with reference to the massive Charleston facility. The Due Process Clause is satisfied in that the tax in question clearly bears fiscal relation to the protection, opportunities and benefits given Humble by this State.

Turning to the question of multiple taxation and the Commerce Clause, the prevention of double taxation is, of course, the whole reason for apportioning income. During the years in question, the South Carolina three factor formula allocated 1.0%, 1.1% and 1.2% of Humble's overall income to this State. The record does not disclose what portion of Humble's income was taxed by all states combined. If, in fact, Humble paid income taxes on more than one hundred (100%) percent of its income to all states combined, it has not attempted to prove that fact. See *Covington Fabrics,* supra. Humble has, however, introduced into evidence foreign laws from a number of states which levy extractions known generally as severance taxes. These taxes are not income taxes, they are privilege taxes. For example, the Texas severance tax is described as an "occupation tax on oil produced measured by number of barrels of oil taken". See *State* v. *Humphrey,* 159 S. W. 2d 162 (1942). It has been settled law for many years that it is not multiple taxation to levy taxes on different incidents, for example, a single taxpayer may pay property taxes, privilege taxes and income taxes and not be subject to multiple taxation. Humble has shown no multiple burden.

* * * * * *

Having determined that the additional tax and interest in question was properly assesed, the Complaint is dismissed and this action ended.

AND IT IS SO ORDERED.

AFFIRMED.

s/ J. Woodrow Lewis C.J.

s/ Bruce Littlejohn A.J.

s/ J. B. Ness A.J.

s/ Wm. L. Rhodes, Jr. A.J.

s/ George T. Gregory, Jr. A.J.

APPENDIX B

STATE OF SOUTH CAROLINA)
COUNTY OF RICHLAND)

IN THE COURT OF COMMON PLEAS

#74-CP-40-1581

EXXON CORPORATION,

Plaintiff,

vs.

SOUTH CAROLINA TAX COMMISSION,

Defendant.

ORDER

This action was brought pursuant to Section 12-47-220 for a refund of $1,720,718.10 income taxes with interest paid under protest. The taxes were assessed on income generated by Humble Oil and Refining Company (Humble). During the years in question, 1970, 1971 and 1972, Humble was a wholly-owned subsidiary of Standard Oil Company of New Jersey (Standard Oil). Standard Oil was an international petroleum company. In contrast to its parent, Humble's activities were primarily domestic. It was engaged in the exploration and production of crude oil and natural gas, in the refining of crude oil and in the sale of petroleum products. Such a combination of activities is often referred to as vertical integration. Humble operated in this State under the trade name of Esso. The present corporate structure came about after the years in question when Humble was merged into Standard Oil which had changed its name to Exxon.

For the years in question, Humble reported its income to this State under a method which excluded from the tax base that portion of its corporate income assigned by the company to its exploration and production activities. Humble reported its income as follows:

	A	B	A-B (with adjustments)
	Net Income of the Corporation	Assigned to Exploration and Production	Income to Which S. C. Ratio Applied
1970	$573,910,020	$474,486,034	$ 75,399,694
1971	679,525,217	533,854,718	110,123,128
1972	624,911,477	549,259,522	34,647,726

On audit the exclusion of the amount assigned to exploration and production activities was disallowed and Humble's liability was computed by applying the South Carolina apportionment ratio to the net income of the corporation less certain minor items which were specifically allocated. The basic question is therefore whether or not the Tax Commission acted properly in applying the apportionment ratio to Humble's corporate income in arriving at a tax base, or whether the ratio should have been applied, as the plaintiff contends, to a lesser amount derived by excluding that portion assigned by Humble to its exploration and production activities. In my opinion the method employed by the defendant Tax Commission is in accordance with the income tax laws of this State and does not violate any constitutional provision. For the reasons which follow, I have determined that the tax in question was properly assessed and collected and that no refund should be granted.

The taxes in question are imposed by Sections 12-7-230 and 12-7-250 of the 1976 South Carolina Code of Laws. Section 12-7-250 states:

> "If a taxpayer * * * is transacting or conducting his business partly within and partly without this State, the income tax * * * shall be imposed upon a base which reasonably represents the portion of the trade or business carried on within this State."

A taxpayer may, of course, operate more than one business. If a single corporation operates two or more "unrelated businesses" within its corporate shell, the Tax Commission seeks to apportion and tax only the income from the business that operates in this State. The Commission Regulation follows:

> "117-87.17 UNRELATED BUSINESS — The phrase 'transacting or conducting his business partly within and party without the State of South Carolina' * * *, is applicable to a single business operation, which is unitary or homogenous and is carried on both within and without the State. * * *. A taxpayer operating a unitary or homogenous business within and without the State and an unrelated business either entirely within or without shall be subject to the allocation formulas with respect to the unitary or homogenous business but not with respect to the unrelated business. The income from the unrelated business shall be directly assignable to the state where such business is conducted."

Humble argues that its exploration and production activities comprise an "unrelated business" and that the income allocated by it to those activities should be directly assigned to the states where such activities are conducted. The defendant Tax Commission on the other hand contends that Humble's exploration and production activities are a part of the company's "single business operation which is unitary" and has therefore refused to allow the plaintiff to reduce its apportionable income by the amount assigned by Humble to its exploration and production activities.

The leading case on the meaning of the term "unitary" as it is used in the area of state taxation of multistate business is *Butler Brothers* v. *McColgan,* 315 U. S. 501, 62 S. Ct. 701. The concept applied in the *Butler Brothers* decision has become known as the "unities" definition. The Supreme Court spoke of "unity of use and management". The California decision which it was affirming had used as its definition unity of ownership, unity of management and unity of operation. See *Butler Brothers* v. *McColgan,* 17 Cal. 2d 664, 111 P. 2d 334 (1942).

In the Supreme Court decision (pages 509 U. S. and 705 S. Ct.), the Court spoke of the "contribution" of the California operations to the business as a whole. It had already addressed the benefits derived by the California operation from the company's business without the state. This interaction of contribution and/or dependence has evolved into the "contribution-dependence" definition which has been used by nearly all state courts that have considered the question of whether or not a business is unitary. Among the states applying the contribution-dependence test are Kansas, Minnesota, Montana, Oklahoma, Oregon, Utah, Virginia and Wisconsin. See *Crawford Manufacturing Co.* v. *State,* 180 Kan. 352, 304 P. 2d 504 (1956); *Western Auto Supply Co.* v. *Commissioner of Taxation,* 245 Minn. 346, 71 N. W. 2d 797 (1955); *Rothchild* v. *Commissioner,* 270 Minn. 245, 133 N. W. 2d 524 (1965); *Great Lakes Pipe Line Co.* v. *Commissioner,* 272 Minn. 403, 138 N. W. 2d 612 (1965); *Montana Dept. of Revenue* v. *American Smelting and Refining Co.,* 567 P. 2d 901 (Mont. 1977); *Oklahoma Tax Commission* v. *Southwestern Bell,* 396 P. 2d 500, 504 (Ok. 1964); *Humble Oil and Refining Co.* v. *Dept. of Revenue,* 4 Oregon Tax Reports 284 (1971); *Hamilton Management Corp.* v. *Commissioner,* 3 Oregon Tax Reports 154, affirmed 253 Or. 602, 457 P. 2d 486 (1969); *Coca Cola Company* v. *Dept. of*

Revenue, 271 Or. 517, 533 P. 2d 788 (1976); *Western Contracting Corp.* v. *State Tax Commission,* 18 Utah 2d 23, 414 P. 2d 579 (1966); *Com., Dept. of Taxation* v. *Lucky Stores, Inc.,* 225 S. E. 2d 870 (Va. 1976) and *Interstate Finance Corp.* v. *Dept. of Taxation,* 28 Wis. 2d 262, 137 N. W. 2d 38 (1965).

The "unities" concept and the "contribution-dependence" test are by no means mutually exclusive. In the decisions cited above, the courts have often applied both definitions in deciding whether or not a business is unitary in nature. The origin of both definitions may be traced to the *Butler Brothers* decision and the activities of a corporation which exhibit unity of ownership, management and operation have usually been found to be activities which are contributory or dependent upon one another.

The South Carolina Supreme Court has not been faced with the question of whether or not a particular business is unitary in nature. A recent case has, however, commented on the term. In *Covington Fabrics* v. *South Carolina Tax Commission,* 264 S. C. 59, 212 S. E. 2d 574, appeal dismissed 96 S. Ct. 14 (1975), our Court said:

> "It is conceded that the business is unitary in nature, therefore its income is attributable to all incidents of the business and not to any single activity."

The Court then quoted a portion, but not all, of the definition used by the North Carolina Court in *State Ex Rel. Maxwell* v. *Kent Coffey Manufacturing Co.,* 204 N. C. 365, 168 S. E. 397, affirmed 54 S. Ct. 437 (1933).

> "That term (unitary) is simply descriptive, and primarily means that the concern to which it is applied is carrying on one kind of business—a business the component parts of which are too closely connected and necessary to each other to justify division or separate consideration, as independent units."

The South Carolina Court did not quote the additional language of the decision which is relied on by Humble, i.e., whether or not the activities sought to be separated are "capable of producing a profit in and of themselves". We did not adopt as our definition the language that the activities of a business are not unitary if they "might be maintained as an independent business (however convenient and profitable it may be to operate them cojointly)". This language lends itself to a definition of unitary in terms of essentiality. Following such a definition, tests of contribution or dependence as well as unity of ownership, management and operation would be irrelevant. In my opinion, a definition of unitary based on whether or not the segments sought to be separated are essential to one another so that one could not be operated without the other, no matter what benefits in the form of cost savings or additional revenues are lost by the separation, is not in conformity with the *Butler Brothers* decision. A California Supreme Court case is directly on point. In *Superior Oil Company* v. *Franchise Tax Board,* 34 Cal. Rptr. 545, 386 P. 2d 33 (1963), the tax collector wanted to separate the company's California production operations and not treat the company as a unitary business. *Superior* was primarily a producing company with wells in California and other states. It refined only a minor portion of its production and most of *Superior's* crude was sold at the wellhead. The Court held that the company operated a "unitary business" as that term is defined in the *Butler Brothers* case, i.e., (1) unity of ownership, (2) unity of operation and, (3) unity of use. It then quoted the contribution-dependence test. The Court went on to specifically reject the "necessary and essential" test now proposed by Humble. In describing the *Butler Brothers* rule, it said:

> "In (the Supreme Court's) view the test was not one based on essential activities but rather one based on contributing activities * * *."

In my opinion, the proper answer to the question of whether or not a business is unitary in nature is given in terms of whether or not the business possesses the characteristics of unity of ownership, unity of management and unity of operation and whether or not the activities of the business in question contribute to or depend on the other activities of the business.

It is next necessary to examine the facts as they relate to Humble. The following statements are taken primarily from the plaintiff's Brief:

Humble's corporate organization structure during the years in issue consisted of three parts: corporate management, coordination and service management (staff services) and operations management. Corporate management was composed of the executive management of the company and was primarily responsible for policy matters. It consisted of the board of directors, the chairman of the board, the president and the directors in charge. The board of directors had the overall responsibility for the activities of the company and was responsible for the policy-making decisions, the overall strategy, and the achievement of the objectives and goals of the company. The chairman of the board was the chief executive of the company and had overall responsibility for implementing the policies of the board and for representing the company before the public. The president had overall responsibility for the operation of the company in its day-to-day activities. The directors in charge were composed of the executive officers of the company including the president and various vice presidents who were also directors of the company. The directors in charge were responsible to the board of directors for the operational management departments of the company and for the coordination and services management departments (staff services) of the company.

Coordination and services management (staff services) consisted of corporate staff departments with the responsibility of providing the specialized services that were needed by the corporation, i.e., corporate planning, secretary, supply, treasury, controllers, tax, law, public affairs, employee relations, general services, medical and aviation. The supply department was responsible for managing of all Humble's domestic crude oil supplies and coordinating the flow of the company's refined products. Generally, the supply department was responsible for assuring that there was an adequate supply of crude oil for Humble's domestic refineries and an adequate supply of refined product for Humble's marketing activities. In fulfilling these responsibilities, the supply department took responsibility for Humble's produced crude as it left the Humble wells. It also purchased crude from outside sources and sold crude to outside parties. During the years in question, Humble was a net purchaser of crude.

Operations management was composed of the executives assigned to the various operating activities of the company. Four departmental vice presidents headed up the four major corporate activities of exploration, production, refining and marketing. Lesser operating departments were supervised by executives titled general managers.

Three departments, exploration, production and natural gas were grouped by Humble and labeled as the corporation's exploration and production function. The exploration department had the responsibility for the profitable acquisition of reserves of crude oil and gas. This department carried on the exploratory effort needed to find potential oil and gas reserves, conducted geological and geophysical studies and surveys and was responsible for drilling wildcat wells. The production department was re-

sponsible for the profitable development and production of all of Humble's oil and gas reserves including the operation of the natural gas plants and related facilities. The natural gas department was responsible for the profitable sale and distribution of natural gas. No attempt was made to separately account for the operation of the natural gas department and the records of its transactions were combined with those of the production department. The refining department was responsible for the profitable operation of Humble's refineries and related facilities which manufactured petroleum products, specialty products and chemical feed stocks. The marketing department was responsible for the profitable distribution and sale of petroleum and specialty products through Humble's marketing facilities.

There were three lesser operating departments. The marine department was responsible for the water-borne transportation of Humble's petroleum products. This department operated Humble's fleet, ocean tankers and inland waterway equipment, and was also responsible for the necessary chartering of any vessels. The minerals department was responsible for the exploration and acquisition of non-hydrocarbon mineral deposits and was also responsible for the development and operation of mines and related facilities. The land management department was responsible for managing Humble's surplus properties and disposing of them as needed.

Additional facts which follow are taken from three separate sets of admissions (38 pages), the depositions of six Exxon employees (350 pages), and the transcript of the trial (689 pages). In addition, I have examined numerous exhibits including certain financial reports prepared by Humble for its internal use.

The four major operating departments were marketing, refining, exploration and production. Although Humble internally accounted for the activities of each of these departments, it has not sought to separate exploration from production in this litigation and the tax returns and internal financial reports which are in evidence account for exploration and production as a single unit which includes the natural gas department. The heads of three departments, marketing, refining and production, were deposed. They were referred to as departmental vice presidents. The testimony of these operating executives establishes a strong day-to-day reliance on the centralized staff services of the corporation. There is no evidence whatsoever that the exploration or production departments were any less dependent on these service departments. The supply department was of great benefit to production as well as refining and marketing. The production vice president was relieved of the responsibility of disposing of the crude as the product left the wellhead by the intervention of the supply department. In addition to furnishing crude to Humble's refineries, supply also had the responsibility of coordinating the movement of refined products (gasoline, oils, etc.) to marketing, thereby relieving the marketing vice president of that burden. Obviously, the responsibilities and burdens of the vice president of refining, who depended on the supply department both for the refineries' source of crude and its outlet of refined product, would have both changed and increased had the supply department not been there.

In addition to its own production, Humble, during the years in question, purchased crude from outside sources. These purchases were made centrally by the supply department of Humble's five major refineries located throughout the United States. Along with purchases of

crude, the supply department through its central purchasing agent made all substantial nonproduct purchases for the company as a whole. These purchases included replacement of the vehicle fleet (about 450 annually) and numerous items for all phases of operation. Substantial cost savings were derived through bulk purchasing discounts. The production department benefited heavily from central purchasing in that all of its capital equipment (pumps, compressors, etc.) were purchased centrally.

With regard to management of operation, it is certainly true that the departmental vice presidents had and exercised a wide range of authority, however, this authority was exercised within well-defined limits set by the executive management of the company who were both directors and officers of the corporation. During the years in question, the departmental vice presidents answered directly to a director in charge to whom they reported at frequent intervals and from whom they sought and received continuous guidance in fulfilling their responsibilities.

The authority for determining who got top-level jobs in the various departments did not rest with the departmental vice presidents. Placement of managers above a certain level was controlled by the executive development committee, a group composed of the chairman of the board of the company, its president and certain corporate officers who were directors. The departmental vice presidents were, of course, consulted about high-level managerial positions in the departments to which they were assigned, however, the decision of who filled these positions was not in their hands. While on the subject of top-level managers within the corporation, I find that the movement of employees throughout the company was a practice which came about as a method of exposing them to various facets of the business so that top talent could

gain experience about the company as a whole. Whether or not this was an announced policy of the company is not, in my opinion, relevant. It is certainly a fact that the corporation drew its top managers and higher executives from all parts of the company. A pool of talent existed which would not have been available had the major operating departments been separate from each other.

The departmental vice presidents were primarily concerned with the duties assigned to them relating to the departments which they supervised. They did not, however, operate in a vacuum and had numerous contacts with each other. All executive management (directors, officers, departmental vice presidents and high-level managers) were located in the corporation's forty-one (41) story headquarters building in Houston where about three thousand (3,000) of the corporation's employees were housed. The staff service departments were also located there. The corporation's business nationwide was centrally directed from these headquarters. The departmental vice presidents had numerous direct contacts with each other. The vice presidents of production, refining and marketing all served on the company's compensation and benefit plan committee. The vice presidents of refining and production were members of the public relations advisory committee. The vice president of marketing was chairman of the product quality committee of which the vice president of refining was a member. Also, executive personnel from the marketing, refining and production departments as well as from the supply and corporate planning departments served on the supply advisory committee. In addition to corporate contacts through the directors in charge and through the various committees, the major operating departments had frequent contact with each other primarily along the lines of the flow of

product, i.e., from crude production to the refineries to gasoline sales. These contacts were beneficial and contributed to the overall operation of the business.

From a financial standpoint, the company was examined in great detail at the trial. Internal company documents showing the assignment to the major operating departments of income and expense as well as assets and liabilities are marked as defendant's Exhibit 11. Exploration, production and natural gas were grouped by the company as one department for purposes of these statements. (These activities will be collectively referred to hereinafter as "E & P".) Before discussing this exhibit upon which the company based its computation of the taxable income for E & P, it is helpful to examine the treatment of crude oil within the corporation. As stated earlier, Humble both purchased and sold crude. No attempt was made by the company to segregate its production from the crude it purchased from outside sources. The company was, however, a net purchaser of crude meaning that it bought more than it sold. From the testimony of a director in charge, Humble refined about a million barrels of crude a day and produced from its own wells about eight hundred thousand barrels. He also testified that the availability of crude purchases was dependent upon production to the extent that if Humble had not had crude available to sell, it probably could not have bought crude. In any case, crude from both sources, Humble's production and Humble's purchases, at least to some extent was mixed in the pipeline system before arrival at Humble refineries. In computing an income for E & P, Humble assigned a transfer price to the crude as it entered the refineries and this transfer price comprised a majority of the gross receipts assigned to E & P. Actual cash sales of crude composed the balance. This transfer

price was based on the posted field price of crude oil which is a price determined and set by the buyer of the crude. The purchase price posted by Humble for its crude purchases was set by the board of directors of the company.

The income assigned by the company to E & P was of such a magnitude that it consistently accounted for about ninety (90%) percent of the corporation's income. Refining and marketing were assigned only four (4%) percent and seven (7%) percent respectively of the corporate income. Along with the relative income assignment, the internal financial statements also showed the corporation's investment assigned to the operating functions. These internal statements reflect that the company's investment in refining and its investment in marketing were both double the company's investment in E & P. The rate of return on assets based on these statements was about thirty (30%) percent for E & P and less than three (3%) percent for marketing and for refining. The statements reflected similar rates of return on equity for these functions. From the testimony presented, I find that the company's internal records reflected similar incomes and returns on capital for many years prior to the years in question. Only in recent years, 1975 and 1976, do the company's internal records show higher rates of return for marketing and refining.

No attempt was made to segregate the earnings shown on the internal financial statements. All investments throughout the company were made from general funds and the officers and directors of the corporation only considered the company's overall ability to finance investments. Earnings and funds were employed by the corporation where they were needed without regard to their source as reflected on internal records. An example of an investment "paid for" by exploration and production according to

these records is the Five Hundred Million Dollar Baytown Refinery. Based on the company's internal assignment of income and assets to the three major functions, I find that the exploration and production function contributed greatly to the marketing and refining functions and that investments made in marketing and refining could not have been made without the existence of the exploration and production function. Also, payment of executives, including the departmental vice presidents, was based on their performance and not on what income the corporation assigned to their particular department. In addition, the departmental vice presidents were participants in an overall company profit sharing plan, not a plan based on the internal computation of income for their departments. They were also members of the company's pension plan.

A further indication of the contribution of exploration and production to marketing and refining is the fact that although marketing and refining had very low rates of return, no borrowing was done by the corporation because of the strength of its overall financial position. Based on the internal records, the cost of capital in terms of interest would have been substantial to the individual departments had the corporation's activities not been integrated. Humble's marketing activities provided a stable outlet for the company's products. Massive actual cash receipts of about Three Billion Dollars a year were generated by marketing. It was here that the primary economic capture of companywide profits through cash sales took place.

Other reasons for vertical integration existed. According to Humble, the combination of all segments of the company provided greater profit stability and reduced risk otherwise inherent in a single-phase company. Also, vertical integration insured full rates of utilization of refining and marketing capacity.

A recapitulation of the facts concerning Humble is: (1) Humble held itself out to the public as one company. It made no attempt to externally identify its exploration and production activities as a separate business. (2) The company employed central staff services upon which all departments were dependent. (3) Humble used centralized purchasing techniques which produced savings throughout the company. (4) Strong centralized management was employed over all segments of the company. (5) The combination of the various activities within a single corporation was beneficial to Humble in that it provided profit stability, reduced risk and insured full capacity utilization of the company's facilities. (6) Humble's crude production and crude sales made crude purchases available for its refineries. (7) High-level personnel within the various departments were selected by upper management, not by departmental vice presidents, and the movement of personnel throughout the company was a beneficial practice employed by Humble. The combination of the various functions created a pool or source of talent which otherwise would not have been available. (8) A central source of earnings and funds was employed and no attempt was made to segregate accumulated earnings or funds based on the company's internal assignment of earnings to these functions. (9) Based on the company's internal assignment of earnings and assets to the various functions, refining and marketing were dependent upon the company as a whole during the years in question. Had the functions not been combined, an additional cost of capital would have existed because of the necessity for borrowed funds. This cost was averted because of the vertical integration of the company. (10) The various operating activities of exploration and production, refining and marketing both contributed to and depended on each other.

In my opinion Humble, during the years in question, was a single unitary business comprised of the exploration and production of crude oil and natural gas, the refining of crude oil and the marketing of natural gas and refined petroleum products. The corporation possessed the characteristics of unity of ownership, unity of management and unity of operation, and the activities of E & P, refining and marketing all contributed to and depended upon each other.

SOUTH CAROLINA ACTIVITIES

Humble's gasoline and oil were sold in this State during the years in question under the trade name "Esso", a name which the company or its predecessors had used here for over thirty (30) continuous years. Humble had approximately thirteen hundred (1,300) gasoline stations in this State, many of which were uniformly designed and constructed by the company in order to promote the sale of its branded gasoline.

Gasoline came into South Carolina from two sources, pipeline and tanker. Humble's tankers continuously used the port of Charleston. At Charleston the company owned and operated a massive facility described as a "terminal". This "terminal" included a product blending operation, a motor oil canning facility and an asphalt plant. The terminal was housed on approximately one hundred ninety (190) contiguous acres of land. (Photographs of the facility are in the record.) Additionally, Humble owned and occupied at Charleston about twenty (20) other lots or parcels of improved realty. Products blended and canned at the Charleston terminal were distributed and sold in neighboring states.

The record discloses an attempt by the Tax Commission to trace the flow of crude oil from the Humble production wells through the refineries and into the Humble gasoline

pumps located within this State. Humble has made no attempt to trace its crude oil production and has consistently maintained that such a tracing is not possible because of the practice among oil companies of mixing certain qualities of crude oil within interlocking pipeline systems. However, the Commission has succeeded in tracing the gasoline reaching the port of Charleston by tanker. Principally, that gasoline came from the Humble refinery at Baytown, Texas. Baytown was in turn fed by crude oil originating both from Humble's production and the production of other companies. An exhibit prepared by the company and entitled "Texas Sources of Crude Available for Baytown Refinery (M barrels)" shows that certain "streams" or qualities of Humble's produced crude were utilized to a high degree by that refinery. For example, during the three years in question a stream or quality of crude labeled coastal heavy was produced almost entirely by Humble and was refined almost entirely at Baytown. Gasoline produced from this crude was transported by Humble's tankers to the Charleston terminal.

Having found that the major operating activities of Humble, consisting of E & P, refining and marketing, constituted one unitary business, it is next necessary to examine the plaintiff's other contentions. The plaintiff has argued that extraterritorial values are being reached and that because of severance taxes levied by numerous oil producing states it is being subjected to multiple taxation.

With regard to the overreach allegation which raises arguments based both on the Due Process Clause and the Commerce Clause of the United States Constitution, our Court stated in the *Covington Fabrics* decision, supra:

> "We have not found a case that supports the corporation's contention that the application of a three factor formula unreasonably apportions income, nor has one

been called to our attention. The formula has however been considered and approved as a reasonable basis for apportioning income. The Supreme Court of the United States, in the case of Butler Bros. v. McColgan, supra, held that:

> 'We cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors *may properly be deemed to reflect "the relative contribution of the activities in the various states to the production of the total unitary income,"* so as to allocate to California its just proportion of the profits earned by the appellant from this unitary business.' (Emphasis added.)"

As stated earlier, Humble transferred a majority of its crude (both produced and purchased) to its refineries. The income computed for E & P was therefore based primarily on transfer prices rather than on actual sales to third parties. This transfer pricing was referred to by Humble's expert accounting witness as "unrealized income". He stated that he would not give an unqualified opinion as to the accuracy of the exploration and production income because the sales were not made to third parties. The defendant Tax Commission has cited authority from the Georgia courts which holds that transfer pricing rather than sales to third parties cannot be used by a multistate corporation in computing divisional income. See *Phillips* v. *Sinclair Refining Co.*, 44 S. E. 2d 671 (Ga. 1947). I find the reasoning of the Georgia case persuasive. It is in line with the conclusion reached by the United States Supreme Court in *Bass, Ratcliff & Gretton* v. *State Tax Commission*, 266 U. S. 271, 45 S. Ct. 82, which held that the unitary business in question there earned no profits until actual sales of its products were made. See also *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U. S.

450, 79 S. Ct. 357, which quotes the same language at page 461 U. S. and 363 S. Ct. Reports. However, under the *Butler Brothers* decision, it is not necessary to impeach Humble's accounting system. The Court stated:

> "It is true that appellant's separate accounting system for its San Francisco branch attributed no net income to California. But we need not impeach the integrity of that accounting system to say that it does not prove appellant's assertion that extraterritorial values are being taxed. Accounting practices for income statements may vary considerably according to the problem at hand. * * *. A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders. * * *."

The plaintiff has placed strong reliance on the case of *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U. S. 123, 51 S. Ct. 385, decided in 1931, ten years prior to the *Butler Brothers* decision. In *Hans Rees* the Supreme Court reversed a decision of the North Carolina Court which had refused to allow the introduction into evidence of proof of the multistate business's earnings in that state. The corporation's activities in North Carolina consisted of manufacturing and the state's archaic income tax apportionment formula which utilized only a single property factor had apportioned over eighty (80%) percent of the company's income there in three years of the four in question. The company had offered evidence to show that only seventeen (17%) percent of its income was earned in North Carolina. The Court stated of the formula applied:

> "For the present purpose, in determining the validity of the statutory method as applied to the appellant, it is not necessary to review the evidence in detail, or to determine as a matter of fact the precise part of the income which should be regarded as attributable to

> the business conducted in North Carolina. It is sufficient to say that, in any aspect of the evidence, and upon the assumption made by the state court with respect to the facts shown, the statutory method, as applied to the appellant's business for the years in question operated unreasonably and arbitrarily, in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state. In this view, the taxes laid were beyond the state's authority. * * *."

The *Hans Rees* decision may be distinguished from the later *Butler Brothers* case on the ground that the California formula of property, payroll and sales more accurately measured the contribution of *Butler Brothers'* California activities to the corporation's unitary income. South Carolina has employed a formula based on these three principles. If *Hans Rees* cannot be distinguished from *Butler Brothers,* the later decision of course controls.

The plaintiff has also relied on the Minnesota decision of *Skelly Oil Company* v. *Commissioner,* 269 Minn. 351, 131 N. W. 2d 632 (1964). I do not find that case persuasive. It is not, in my opinion, in line with the *Butler Brothers* case or the great weight of authority throughout the country which has stemmed from the *Butler Brothers* decision. The *Skelly* decision is perhaps distinguishable based on the fact that *Skelly* proved that only nine (9%) percent of the crude oil it produced was used in its refineries thereby giving the Minnesota Court at least some basis upon which to affirm the Lower Court's fact finding that the production activities of the corporation formed a business that was separate from the refining and marketing functions. Furthermore, the interdependence found to be lacking in *Skelly* was present in Humble. In *Skelly,* the Lower Court had found that decisions about exploration and production, such as where, when and in what volume the oil was to be produced, were decided entirely by the departments in

charge of those activities without regard to the needs of *Skelly's* refineries or markets. Based on the record before me, this was certainly not the case with Humble. Also, *Skelly* apparently had no supply department because no need existed to coordinate its production department with the rest of the company. Such a need obviously existed at Humble.

A court's primary concern in the due process area is not to improvise a method for computing taxes, but to inquire as to whether or not the method provided imposes a tax which bears a reasonable relationship to the taxpayer's activities in this State. As stated in the case of *Wisconsin* v. *J. C. Penney Co.,* 311 U. S. 435, 61 S. Ct. 246, page 250 (1940):

> "* * *. That test (due process) is whether property was taken without due process of law, or, if paraphrase we must, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return. The substantial privilege of carrying on business in Wisconsin, which has here been given, clearly supports the tax, and the state has not given the less merely because it has conditioned the demand of the exaction upon happenings outside its own borders. The fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction. * * *."

The South Carolina activities of Humble were substantial particularly when viewed with reference to the massive Charleston facility. The Due Process Clause is satisfied in that the tax in question clearly bears fiscal relation to the protection, opportunities and benefits given Humble by this State.

Turning to the question of multiple taxation and the Commerce Clause, the prevention of double taxation is, of course, the whole reason for apportioning income. During the years in question, the South Carolina three factor formula allocated 1.0%, 1.1% and 1.2% of Humble's overall income to this State. The record does not disclose what portion of Humble's income was taxed by all states combined. If, in fact, Humble paid income taxes on more than one hundred (100%) percent of its income to all states combined, it has not attempted to prove that fact. See *Covington Fabrics,* supra. Humble has, however, introduced into evidence foreign laws from a number of states which levy extractions known generally as severance taxes. These taxes are not income taxes, they are privilege taxes. For example, the Texas severance tax is described as an "occupation tax on oil produced measured by number of barrels of oil taken". See *State* v. *Humphrey,* 159 S. W. 2d 162 (1942). It has been settled law for many years that it is not multiple taxation to levy taxes on different incidents, for example, a single taxpayer may pay property taxes, privilege taxes and income taxes and not be subject to multiple taxation. Humble has shown no multiple burden.

It is alleged in the Complaint that the South Carolina statute which allows percentage depletion only on deposits located within this State is unconstitutional. See Section 12-7-700(8) of the 1976 South Carolina Code of Laws. However, the plaintiff has stated that "it does not intend to press this allegation". The manner was not argued before me and I have not been asked to decide the question. I will therefore not comment on it. The plaintiff has insisted that this question has not been abandoned and that it has "reserved the right to raise the argument at any time". When and if it raises the argument, its right to do so can be decided then.

Finally, during discovery proceedings prior to the trial of this matter, I handed down an order of confidentiality prohibiting the disclosure of information relating to the plaintiff's internal financial statements. These statements were later made a part of the record in this case and extensive cross-examination of witnesses concerning the statements is contained in the Transcript. These internal financial statements form the underlying documents from which the plaintiff allocated its corporate income for tax purposes to its various departments. No compelling reason was given by plaintiff to keep these financial records, which now vary in age from five (5) to seven (7) years, confidential. The confidentiality order of October 13, 1977, is hereby rescinded.

Having determined that the additional tax and interest in question was properly assessed, the Complaint is dismissed and this action ended.

AND IT IS SO ORDERED.

/s/ Joseph R. Moss
JOSEPH R. MOSS
Special Judge, Fifth Judicial Circuit

April 8, 1978

APPENDIX C

IN THE SUPREME COURT OF THE STATE OF SOUTH CAROLINA

EXXON CORPORATION,

Appellant,

v.

SOUTH CAROLINA TAX COMMISSION,

Appellee.

NO.

NOTICE OF APPEAL TO THE SUPREME COURT OF THE UNITED STATES

NOTICE IS HEREBY GIVEN that EXXON CORPORATION, Appellant, hereby appeals to the Supreme Court of the United States from the final judgment (258 S.E. 2d 93) of the Supreme Court of the State of South Carolina affirming a judgment of The Court of Common Pleas, Fifth Judicial Circuit, South Carolina, which final judgment was entered in this proceeding on September 5, 1979.

This appeal is taken pursuant to 28 U.S.C. §1257 (2).

BOYD, KNOWLTON, TATE & FINLAY
BY: /s/ *Charles W. Knowlton*
Twelfth Floor SCN Center
1122 Lady Street
Columbia, South Carolina 29201

DATED: Nov. 20, 1979

STATE OF SOUTH CAROLINA)
) SS.
COUNTY OF RICHLAND)

IN THE SUPREME COURT OF THE STATE OF SOUTH CAROLINA

EXXON CORPORATION,

Appellant,

v.

SOUTH CAROLINA TAX COMMISSION,

Appellee.

NO.

AFFIDAVIT OF FILING OF NOTICE OF APPEAL FILED WITH THE SUPREME COURT OF SOUTH CAROLINA AND OF SERVICE ON ALL PARTIES

I, John C. Burton, Jr., being duly sworn under oath, state that, on this date, I have personally filed a Notice of Appeal with the Clerk of the Supreme Court of South Carolina, and have personally served a copy of the Notice of Appeal on counsel of record for Appellee at the following address:

Deputy Attorney General Joe L. Allen, Jr.

Calhoun State Office Building

Columbia, South Carolina 29201

I further state that all parties required to be served with the Notice of Appeal filed by Exxon Corporation with the South Carolina Supreme Court have been served.

I further state that this Proof of Service has been filed with the Clerk of the Supreme Court of South Carolina concurrently with the filing therewith of the Notice of Appeal.

DATED: Nov. 20, 1979

/s/ *John C. Burton, Jr.*
John C. Burton, Jr.
Boyd, Knowlton, Tate & Finlay
Twelfth Floor SCN Center
1122 Lady Street
Columbia, South Carolina 29201

SUBSCRIBED AND SWORN TO
before me this 20th day
of November, 1979.

/s/ *R. G. Bolick*

Notary Public For South Carolina

My Commission expires: 8/16/89

APPENDIX D

Sec. 12-7-250. Tax on businesses transacted or conducted partly within and partly without the State.—If any taxpayer, except those defined in former 1962 Code § 65-256, is transacting or conducting his business partly within and partly without this State, the income tax as provided in this chapter shall be imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State. The taxpayer subject to taxation under this section shall be deemed to have been transacting or conducting his business partly within and partly without the State if such taxpayer is subject to a net income tax or a franchise tax measured by net income in any other state, the District of Columbia, a territory or possession of the United States, or any foreign country, or would be subject to the net income tax in any other such taxing jurisdiction if such other taxing jurisdiction adopted the net income tax laws of this State. *Provided,* that nothing herein shall operate to deny any taxpayer affected by this section and §§ 12-7-230, 12-7-240, and 12-7-1110 to 12-7-1200 the benefits of § 12-7-700 (12) where such taxpayer suffers a net loss, but as to the apportionment of net operating losses carried forward, the provisions of those sections apply as if the taxpayer had a net income.

APPENDIX E

Sec. 12-7-1130. Allocation of income from any other investments.—The income less all related expenses from any other investments, including investments in subsidiaries, the net income from which is not properly includable in the net apportionable income of corporations engaged in interstate commerce under the Constitution of the United States because it is unrelated to the business activity of the corporation conducted partly within and partly without South Carolina, shall be allocated to the state in which the business situs of the investment is located; *provided,* that if the business situs of such investment is partly within and partly without South Carolina, it shall be apportioned by use of the same formula as provided for apportioning the net income of the corporation.

APPENDIX F

STATE OF SOUTH CAROLINA)
COUNTY OF RICHLAND)

IN THE COURT OF COMMON PLEAS

EXXON CORPORATION,

Plaintiff,

-vs-

SOUTH CAROLINA TAX COMMISSION,

Defendant.

COMPLAINT

Plaintiff alleges:

1. Plaintiff is a New Jersey corporation with its principal place of business in the State of New York. Plaintiff is successor to Humble Oil & Refining Company by merger effective January 1, 1973. Plaintiff is qualified to do business in South Carolina and is in good standing.

2. Defendant is a South Carolina state agency charged with assessment and collection of income taxes owing to the State of South Carolina.

3. Pursuant to S. C. Code §65-2661, on November 18, 1974, plaintiff made payment to defendant, under protest, of South Carolina income taxes for the calendar years 1970, 1971, and 1972 in the total amount of $1,490,855.00, plus interest thereon in the amount of $229,863.10, making a total payment of $1,720,718.10.

4. This action is brought pursuant to S. C. Code §65-2262 for recovery of such taxes and interest which were wrongfully and illegally collected.

5. The South Carolina income tax on a taxpayer which conducts its business partly within and partly without South Carolina is required to be "imposed upon a base which reasonably represents the proportion of the trade or business carried on within this State." S. C. Code §65-222.2. South Carolina does not impose a tax on such a taxpayer's entire net income, but only on the part of the income which is deemed to be earned in South Carolina. In order to determine how much of a taxpayer's income is earned in this state, South Carolina law specifically allocates certain parts of a taxpayer's total income to other states and does not include them as part of the taxpayer's income which is subject to apportionment among the states. S. C. Code §§65-279.1, 65-279.2. After thus identifying the amount of the taxpayer's income which is subject to apportionment, South Carolina law provides that a certain fraction of the apportionable income shall be treated as income earned in South Carolina. The fraction used to apportion income is derived from the ratio of taxpayer's sales, property and payroll in South Carolina to its sales, property and payroll everywhere. S. C. Code §§65-279.3, *et seq.*

6. Defendant has incorrectly determined the amount of plaintiff's income which is subject to apportionment. Plaintiff does not challenge the fraction used to apportion part of this income to South Carolina.

7. Plaintiff is a multistate business corporation engaged in a number of functions in the United States, including:

(a) exploration for oil and gas,

(b) production or extraction of oil and gas from the ground,

(c) refining of crude oil,

(d) marketing of petroleum products, and

(e) other functional operations.

Each of these functions is managed and accounted for on a functional operating basis. Each is a segment of plaintiff's total corporate enterprise, but each has its own accounting, budgeting and forecasting, its own management and staff, its own profit center, its own investment center, its own physical facilities, etc. The profit or loss of each function is separately and accurately computed.

8. Plaintiff's functional operations in South Carolina are confined to marketing and minor land management operations. All sales in South Carolina are made by plaintiff's marketing department; all properties owned by plaintiff in South Carolina are carried on the books of its marketing department; and all payrolls paid in South Carolina are paid by its marketing department. Plaintiff has absolutely no exploration, production, refining or other activities or properties in South Carolina.

9. Even though plaintiff's functional operations in South Carolina are confined to its marketing function and its minor land management operations, defendant has, by means of the application of the above-described apportionment formula to plaintiff's entire net income from all the above-described functional operations in the United States, required plaintiff to pay South Carolina income taxes on a fractional portion thereof, this notwithstanding that a substantial portion of such income was earned or derived from operations carried on and properties situ-

ated outside South Carolina. Illegally included in such income base for South Carolina tax purposes were (a) situs income from the exploration and production function allocable to the states in which the properties and operations were situated and carried on, (b) situs income from other functional operations carried on from properties outside South Carolina, and (c) income from the refining function carried on from properties and operations outside the State.

10. This incorrect use of plaintiff entire United States net income as its income subject to apportionment has the effect of increasing the amount of plaintiff's income subject to tax in South Carolina for the three years involved here from approximately four million dollars to approximately twenty-nine million dollars. This 700% increase is attributable almost entirely to plaintiff's income from its exploration and production functions, none of which is conducted in South Carolina. Moreover, whereas percentage depletion is allowed by defendant in the determination of taxable income from oil and gas operations conducted in South Carolina, defendant, in the process of computing plaintiff's total net income for apportionment purposes, illegally permitted plaintiff only a cost depletion reduction for its out-of-state oil and gas production income, thereby increasing plaintiff's South Carolina tax by an amount in excess of $550,000.00 for the years in issue.

11. All of plaintiff's exploration and production income is subject to tax by the states in which this function is conducted. These production states include the income from exploration and production in those states in their respective tax bases. Thus plaintiff's exploration and production income is subject to double taxation as a result

of defendant's wrongful inclusion of such income in plaintiff's taxable income, a fraction of which is taxed by South Carolina.

12. Defendant's method of assessing taxes against plaintiff is wrongful, arbitrary, capricious and illegal and is not in accordance with South Carolina income tax law, specifically §§65-222, 65-222.2, 65-259(8), 65-279.2, and 65-279.1, and is not in conformance with defendant's own Rule I-R-23.

13. Plaintiff maintains books of account and records in such manner as to clearly reflect its true net income accruing or arising from sources within South Carolina and its true net income from sources without South Carolina. Defendant has arbitrarily, capriciously, and unlawfully denied plaintiff the right to file tax returns and calculate its tax based upon its net income arising from sources within South Carolina as determined by such books, as permitted by S. C. Code §65-279.11.

14. If defendant's method of computing plaintiff's taxable income is held to comply with S. C. Code §§65-222, 65-222.2, 65-259(8), 65-279.2 and 65-279.1, then one or more of said statutes, on its face or as applied to plaintiff, is in violation of the due process clause of the South Carolina Constitution, Article I, Section 5.

15. If defendant's method of computing plaintiff's taxable income is held to comply with S. C. Code §§ 65-222, 65-222.2, 65-259(8), 65-297.2 and 65-299.1, then one or more of said statutes, on its face or as applied to plaintiff, is in violation of the due process clause of the Fourteenth Amendment of the United States Constitution, and the commerce clause of Article I, Section 8(3) of the United States Constitution.

APPENDIX G

HUMBLE OIL & REFINING COMPANY

1970 - 1972 South Carolina Corporation Income Tax Audit
Summary of Alternative Methods of Attributing Net Income to South Carolina

Year	States Apportionment Method		Allocation & Apportionment of Operating Departments/ Segments Other Than Exploration & Production of Oil, Gas, and Other Minerals		Allocation & Apportionment of Marketing Function		Allocation & Apportionment of Marketing and Refining Functions	
	Taxable Income	Tax	Taxable Income	Tax	Taxable Income	Tax	Taxable Income	Tax
1970	$ 8,275,624	$ 496,537	$1,302,922	$ 78,175	$3,412,881	$204,773	$1,947,649	$116,859
1971	10,468,409	628,105	2,083,533	125,012	2,090,500	125,430	2,021,793	121,308
1972	10,181,118	610,867	889,639	53,378	1,337,276	80,237	1,543,357	92,601
Totals	$28,925,151	$1,735,509	$4,276,094	$256,565	$6,840,657	$410,440	$5,512,799	$330,768
	(From Audit Report)		(From Schedule C)		(From Schedule D)		(From Schedule E)	
Differences with State Audit and:								
(a) Exploration and Production As Separate Business or Allocation to Situs			$24,649,057	$1,478,944				
(b) Marketing Function Apportioned Only					$22,084,494	$1,325,069		
(c) Marketing and Refining Functions Apportioned Only							$23,412,352	$1,404,741

NOTE: This schedule summarizes the resulting South Carolina net taxable income and income tax liability under three alternative conclusions as to the method for arriving at the net income attributable to Humble's activities in South Carolina during the years 1970 through 1972.

(1) Exploration and Production functions' net income treated as (a) separate out-of-state businesses or (b) as allocated to situs, with all other non-allocable net income of Humble apportioned under the statutory three factor formula. Return method adjusted for items not protested on audit.

(2) Marketing functional department's net income allocated and apportioned to South Carolina under the statutory formula and all other income treated as from separate out-of-state business.

(3) Marketing and Refining functional departments' combined net income allocated and apportioned to South Carolina under the statutory formula and all other income treated as from separate out-of-state business.

Supreme Court, U. S.
FILED
DEC 26 1979
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-843

EXXON CORPORATION, APPELLANT,

versus

SOUTH CAROLINA TAX COMMISSION, APPELLEE

ON APPEAL FROM THE SUPREME COURT OF SOUTH CAROLINA

MOTION TO DISMISS AND/OR AFFIRM

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INDEX

MOTION TO DISMISS AND/OR AFFIRM

PAGE

Argument 2

I. Motion to Dismiss
Lack of a Substantial Federal Question

Conclusion 6

Argument 6

II. Motion to Affirm
Decision of the South Carolina Supreme Court Amply Supported by the Record and Decisions of This Honorable Court

Conclusion 10

CASES CITED

	PAGE
Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission, 266 U. S. 271, 45 S. Ct. 82	6
Johns-Manville Products Corp. v. Commissioner of Revenue Administration, 115 N. H. 428, 343 A. 2d 221; Appeal Dismissed, 423 U. S. 1069, 47 L. Ed. 2d 79, 96 S. Ct. 851	5
Moorman Manufacturing Co. v. Bair, 98 S. Ct. 2340	4, 8
Northwestern States Portland Cement Co. v. State of Minnesota, 358 U. S. 464, 795 S. Ct. 357	5, 8
Underwood Typewriter Co. v. Chamberlain, 254 U. S. 113, 41 S. Ct. 45, 65 L. Ed. 165	4
United States Steel Corp. v. Multistate Tax Commission, 98 S. Ct. 799	4

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. .....

EXXON CORPORATION, APPELLANT,

versus

SOUTH CAROLINA TAX COMMISSION, APPELLEE

ON APPEAL FROM THE SUPREME COURT OF SOUTH CAROLINA

MOTION TO DISMISS AND/OR AFFIRM

The Appellee, pursuant to Rule 16 of the Rules of this Honorable Court, respectfully moves that the appeal herein made from the Order of the Supreme Court of the State of South Carolina be dismissed because the said appeal does not present a substantial federal question, or in the alternative, that the Order be affirmed because the disposition of the issue is settled by existing decisions of this Honorable Court, or because the decision of the Supreme Court of South Carolina is fully supported by the record.

I

ARGUMENT

MOTION TO DISMISS

No substantial Federal question is presented.

The Court is asked to take jurisdiction of this case upon the grounds that South Carolina Code §§ 12-7-250 and 12-7-1130 are repugnant to the Constitution of the United States. Three questions are presented alleging the two sections to be unconstitutional because the same contravene the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of the United States Constitution.

Neither the Jurisdictional Statement nor the questions, however, place in issue the concurrent factual findings of the Supreme Court of South Carolina and the Court of Common Pleas of Richland County. The facts thus found by the South Carolina Courts and not here contested should be binding. Both South Carolina courts found that the Appellant during the years involved conducted a unitary business and that its apportioned income from the unitary business was subject to taxation by the State. This was the substantive holding of those courts and, as stated, such is not placed in issue by the Jurisdictional Statement or the three questions.

If error was committed by the courts, which is assuredly denied, the same would be that of finding from the facts presented that the Appellant conducted a unitary business with the Exploration and Production of crude oil related thereto.

By reason of the Jurisdictional Statement and questions, the only issue thus before this Court is whether the South Carolina statute that imposes an income tax on a unitary business conducted within and without the State upon an income base that represents the proportion of the

trade or business carried on within the State conflicts with the requirements of due process or burdens interstate commerce. Obviously, the sections do not. The tax is apportioned by use of the three factor formula. The Appellant acknowledges that the formula reasonably apportions the income.

In its argument that substantial federal questions are presented, the Appellant states that it does not raise the question of the right of the State to tax income from a multistate business or the applicability of the apportionment formula. The appellant more importantly admits that it does not question the "(3) validity of the three factor formula of South Carolina when properly applied." (See page 13 of the Jurisdictional Statement.) Whether it has been properly applied must of necessity be determined upon the findings of facts but these findings of facts are not in issue. Here, neither the statement nor the questions dispute the fact that the Appellant conducts a unitary business. The fact that a segment of this unitary business is conducted without the State does not preclude the inclusion of the income attributed to that activity in apportionable income.

The Appellant thus prosecutes this appeal for this Court to review and reconsider the facts and find from the evidence presented that income attributable to its Exploration and Production of crude oil is unrelated and a separate business activity from its refining and marketing of petroleum products. It has failed, however, to raise this issue.

Added support for the above is evidenced by the "substantial concepts" asserted in the statement. The Appellant first contends that a corporate entity cannot be found to be unitary based only upon an examination of the corporation's management structure and the nondelineation publicly of its separate operational functions; the second contention is that of whether situs income can also be included

in apportioned income and, finally, it is contended that multiple taxation as a burden on commerce depends on the fact, rather than the power of a situs state to tax.

The first contention is without factual support. Clearly, the decisions of the South Carolina courts were not based or predicated upon such a limited factual consideration. The record is substantial and clearly reflects a full consideration of all of the Appellant's business activities. There were thirty-eight pages of admission, six depositions with 350 pages of testimony, a transcript of 689 pages and the exhibits considered by the Court (Appendix B, App. 24 of the statement). These facts standing alone negate the Appellant's assertions that only the corporate structure was considered. The facts set forth in both Orders establish beyond doubt that the courts' holdings were predicated on all the evidence, including the relationship of the various so-called functional operations.

With reference to the other two contentions, it appears well settled that South Carolina is not precluded from taxing income from business activities just because some other state may be taxing the business activity within that state. It has long been settled that the states are free to employ the unitary business standard. *Underwood Typewriter Co. v. Chamberlain,* 254 U. S. 113, 41 S. Ct. 45, 65 L. Ed. 165; *United States Steel Corp. v. Multistate Tax Commission,* 98 S. Ct. 799.

The rule is that the Appellant must factually prove that the South Carolina statutes discriminately subject its income to taxation. This Court again recognized in *Moorman Mfg. Co. v. Bair,* 98 S. Ct. 2340, that no uniform system for apportioning income exists; that such possibly results in multiple taxation, however, the same was insufficient to invalidate the state law. Here the Appellant has shown no

evidence that more than 100% of its income is taxed by the taxing authorities in which it does business.

In the case of *Johns-Manville Products Corp. v. Commissioner of Revenue Administration,* 115 N. H. 428, 343 A. 2d 221, the court was confronted with a similar question. In that case the income from the sale of timberland in Mississippi was subject to taxation by Mississippi and the gain was also included in apportionable income in New Hampshire. It was argued that this was unlawful because of multiple taxation. The Supreme Court of New Hampshire held that:

> "Plaintiff argues further that since Mississippi has taxed the entire gain, the decision of the board will result in multiple taxation. Even if this were a valid objection (*Illinois Cent. R. Co. v. Minnesota,* 309 U. S. 157 (1940); *State Tax Comm'n. v. Aldrich,* 316 U. S. 174 (1942); *Northwestern States Portland Cement Co. v. Minnesota,* 358 U. S. 450 (1959); *General Motors Corp. v. Washington,* 377 U. S. 435 (1964), plaintiff's complaint should not be directed against New Hampshire whose tax is fairly apportioned and constitutionally proper."

An appeal of that decision to this Honorable Court was dismissed for "want of a substantial federal question". 423 U. S. 1069, 47 L. Ed. 2d 79, 96 S. Ct. 851.

No difference exists between that case and the present case. The fact that some other state may have taxed the income that the Appellant allocates to its Exploration and Production activity is no bar to South Carolina including that income in its apportionment formula. The South Carolina tax is apportioned by a formula that the Appellant admits to be reasonable and is not in issue. The record clearly establishes that no substantial federal question is in issue.

CONCLUSION

No substantial federal question exists in this action. It is not unlawful to properly apportion the income of a unitary business and to include therein that income that is attributable to the out-of-state activity. The Appellant's effort to convert the factual findings into a declaration of the unconstitutionality of the South Carolina statutes must fail. We respectfully submit that the appeal should be dismissed.

II

ARGUMENT

MOTION TO AFFIRM

The decision of the South Carolina Supreme Court should be affirmed in that the same is abundantly supported by the record and is in conformity with the decisions of this Honorable Court.

The Appellant admittedly is engaged in the business of marketing petroleum products. Its activities consist of finding and producing crude oil, the refining of such crude and the sale of the petroleum products to its customers. It is this last transaction from which the income was earned. This Court in the case of *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,* 266 U. S. 271, 45 S. Ct. 82, was confronted with the taxation of a manufacturer of ale. The ale was brewed in England and imported and sold through branch offices located in New York City and Chicago. The question was whether the inclusion of the income from the activity in England burdened foreign commerce. The Court held:

> "So in the present case we are of opinion that as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places—**the process of manufacturing resulting in no profits until it ends in sales**—the State was justified in attributing to New York a just proportion of profits earned by the Company from such unitary business." (Emphasis added.)

The Appellant states that its Exploration and Production is separate and unrelated to its refining and marketing activity. Such contention was discarded, however, by the South Carolina courts. We submit that the record sustains the holdings of the South Carolina Courts and that the Appellant's contention is without factual support. Much is said about accounting, however, we would ask the question of when did accounting and form take precedent over substance in tax matters. Substance, not form, has long controlled the disposition of tax questions.

For a support of the above, the Court's attention is called to the factual findings set forth in the Order of the Court of Common Pleas of Richland County (Appendix B) and the Order of the Supreme Court of South Carolina (Appendix A). The Appellant allocated the majority of its income to Exploration and Production, about 90%, with 4% and 7% allocated to refining and marketing (Appendix B, App. 29 of the statement).

At this point it should be noted that the Appellant's production of crude was transferred to its supply department and then refined or sold to others. Significance must also be given to the fact that the Appellant refined approximately 1,000,000 barrels of crude per day and produced about 800,000 barrels of that amount (Appendix B, App. 20 of the statement).

Also of importance is the fact that the income attributable to all of the functions entered into one company treasury. The alleged income from Exploration and Production was used by the company to build refineries, to make other

investments and to pay ordinary corporate expenses, such as salaries.

These facts clearly sustain the factual holding of the South Carolina courts that the Appellant conducted a unitary business.

It should also be noted that the Appellant alleges that it produces its crude, sells the same to its supply department, that then sells to its refining department, that then sells to its marketing department. How is it possible for the Appellant to sell itself something it already owns or how can it transfer something to itself that is in its possession? Strong reliance is made upon posted field prices, however, these are prices that the Appellant sets. In other words, it says we will pay ourselves so much for the crude. Admittedly, some crude is sold to others, however, this is a matter of convenience and where is the evidence to establish such sales in comparison to total production. Additionally, the availability of crude was dependent upon production (Appendix B, App. 28).

Before concluding argument on this motion, attention is called to the settled law of this Honorable Court that sustains the right of the states to tax the income of the Appellant's unitary business. *Moorman Mfg. Co. v. Bair,* 98 S. Ct. 2340, is the latest consideration of the issue.

The tax is not an unapportioned tax that by its nature subjects interstate commerce to an unfair burden. In the case of *N. W. States Portland Cement Co. v. State of Minn.,* 358 U. S. 464, 795 S. Ct. 357, the court held:

> "This is not an unapportioned tax which by its very nature makes interstate commerce bear more than its fair share. As was said in *Central Greyhound Lines of New York v. Mealey,* 1948, 334 U. S. 653, 661, 68 S. Ct. 1260, 1265, 92 L. Ed. 1633, 'it is interstate commerce which the State is seeking to reach and * * * the real question [is] whether what the State is exacting is a

> constitutionally fair demand by the State for that aspect of the interstate commerce to which the State bears a special relation.' The apportioned tax is designed to meet this very requirement and 'to prevent the levying of such taxes as will discriminate against or prohibit the interstate activities or will place the interstate commerce at a disadvantage relative to local commerce.' *Id.,* 334 U. S. at page 670, 68 S. Ct. at page 1270. Logically it is impossible, when the tax is fairly apportioned, to have the same income tax twice. In practical operation, however, apportionment formulas being what they are, the possibility of the contrary is not foreclosed, especially by levies in domiciliary States. But that question is not before us. It was argued in *Northwest Airlines v. State of Minnesota,* 1944, 322 U. S. 292, 64 S. Ct. 950, 952, 88 L. Ed. 1283, that the taxation of the entire fleet of its airplanes in that State would result in multiple taxation since other States levied taxes on some proportion of the full value thereof. The Court rejected this contention as being 'not now before us' even though other States actually collected property taxes for the same year from Northwest upon 'some proportion' of the full value of its fleet. Here the records are all to the contrary. There is nothing to show that multiple taxation is present. We cannot deal in abstractions. In this type of case the taxpayers must show that the formula places a burden upon interstate commerce in a constitutional sense. This they have failed to do."

The Appellant has failed to establish an unfair burden. The South Carolina Supreme Court in its Order stated:

> "Turning to the question of multiple taxation and the Commerce Clause, the prevention of double taxation is, of course, the whole reason for apportioning income. During the years in question, the South Carolina three factor formula allocated 1.0%, 1.1% and 1.2% of Humble's overall income to this State. The record does not disclose what portion of Humble's income was taxed by all states combined. If, in fact, Humble paid income

taxes on more than one hundred (100%) percent of its income to all states combined, it has not attempted to prove that fact. See *Covington Fabrics, supra.* Humble has, however, introduced into evidence foreign laws from a number of states which levy extractions known generally as severance taxes. These taxes are not income taxes, they are privilege taxes. For example, the Texas severance tax is described as an 'occupation tax on oil produced measured by number of barrels of oil taken'. See *State v. Humphrey,* 159 S. W. 2d 162 (1942). It has been settled law for many years that it is not multiple taxation to levy taxes on different incidents, for example, a single taxpayer may pay property taxes, privilege taxes and income taxes and not be subject to multiple taxation. Humble has shown no multiple burden." (Appendix A, p. 14.)

The above negate the Appellant's assertion of the unconstitutionality of the South Carolina statutes.

CONCLUSION

The evidence conclusively establishes the correctness of the decision of the South Carolina Supreme Court. It is supported by fact and judicial declaration of this Honorable Court and the Order should be affirmed.

Respectfully submitted,

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